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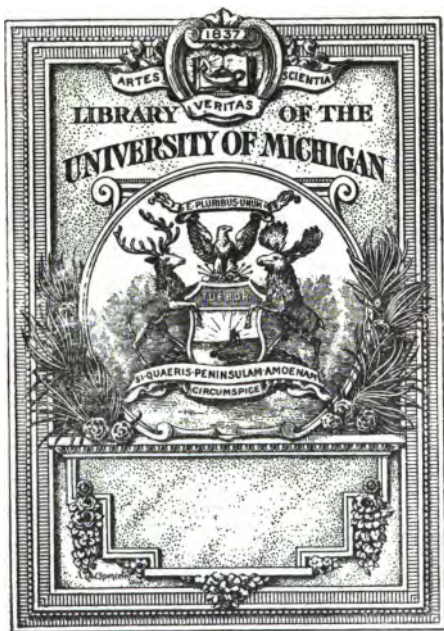
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**NET WORTH AND THE
BALANCE SHEET**

Net Worth and the Balance Sheet

By
HERBERT G. STOCKWELL, C.P.A.



New York
The Ronald Press Company
1912

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EXPLANATION OF THE BOOK

SHREWD business men take pains to learn enough about the accounts on their books to know where they stand at any time and whether the business is going forward or backward, and why.

To such men the knowledge of the vital facts of the business, as shown in their books, provides means by which complete mastery of the business may be obtained.

But these shrewd men are few in number compared with the many who do not take the trouble to solve the meaning of the accounts in which the history of the business is being recorded.

Such men, finding the study of facts expressed in figures unattractive, too often leave the matter of bookkeeping entirely to their clerks, easily yielding to the difficulty of obtaining the correct interpretation of their accounts.

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In many other cases the proprietors, with little or no bookkeeping knowledge, yet dimly seeing the advantages to be gained by greater knowledge, continually struggle in unavailing efforts to comprehend the figures presented to them by their bookkeepers.

Whether the failure to grasp the important facts of a business results from insufficient attempts on the part of the proprietor or follows earnest efforts, ignorance of the true financial conditions has been the cause of many bankruptcies which might have been avoided had impending danger been known in time.

If there is one business law of more importance than any other, it surely rests in the common-sense principle that a business man should know at all times where his business stands in relation to his creditors, and to his partners or shareholders. Within reasonable approximation he should know his "net worth."

In order fully to comprehend all that is involved in his net worth, he must acquire at least sufficient knowledge of the expres-

sion of business facts in figures to enable him to read and understand the meaning of his balance sheet, or statement of assets and liabilities.

In obtaining this knowledge he will find that, as his stock of accounting information increases, along with each new comprehension will come a growing strength and ability to grasp each business condition as it arises.

Besides the additional control over his own business, obtained in the study of his accounts, he will gain the power of analyzing the balance sheets of other concerns in whose financial condition he may, for one or more of many reasons, be interested.

Few indeed are the concerns engaged in banking, manufacturing, or trading to whom credit for money or merchandise is not granted, or who do not grant credit to others upon signed statements or mercantile reports.

Moreover, the investor in the bonds or stocks of corporations would be less dependent upon quotations, rumors, or advice of friends if he could himself understand the balance sheets of the corporations whose

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stocks and bonds are offered to him for investment.

Thus it appears that all men of independent means as well as those in business would find advantages in the possession of a moderate amount of bookkeeping knowledge, sufficient, at least, to enable them to understand the accounts representing assets and liabilities on a balance sheet, and the net worth produced by the proper assembling of those accounts.

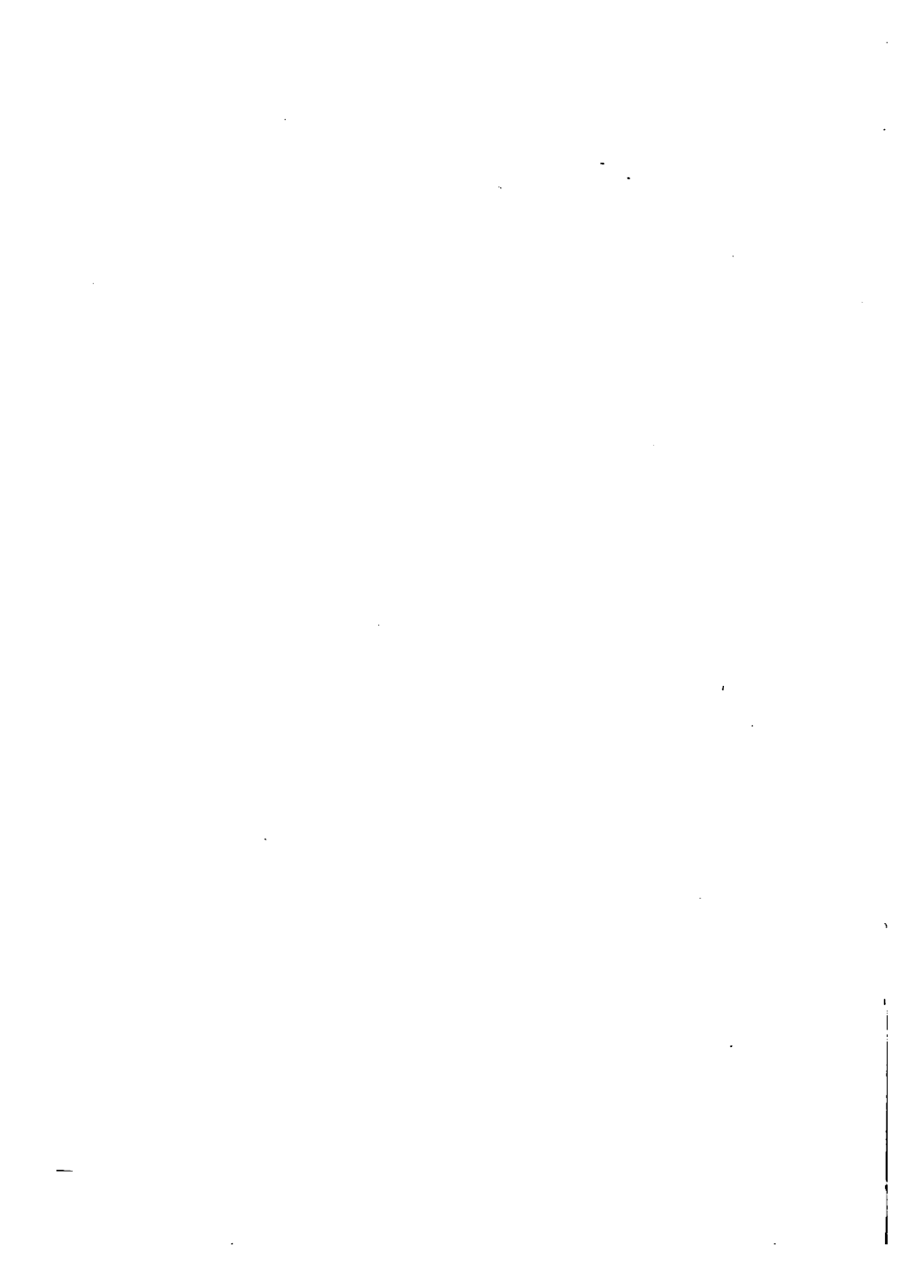
The present work is intended to be of assistance to all those whose duty or interest compels either the preparation or inspection of balance sheets of merchants or manufacturers. It endeavors to explain the nature of the items involved, to point out what the balance sheet does or should show; and to furnish such information as will enable those seeking further knowledge of the condition of any concern than is shown by its balance sheet to frame intelligent inquiries of the management, tending to bring out the information desired.

The present volume, as intimated, is con-

financed almost entirely to the ordinary balance sheet of the merchant and manufacturer. To interpret the business conditions shown by the balance sheets of steam and electric railroad corporations, electric light and power corporations, water and gas companies, and, last but not by any means least, national, state, and municipal governments, would require much more elaboration than can be brought within the limits of the present work. The wide and interesting field of accounting methods involved when business and financial facts of these balance sheets are expressed in figures, will well repay investigation and may be the subject of a second volume.

The definitions appearing in italics have been framed in an effort to simplify some of the terms commonly used by business men, bookkeepers, and accountants.

H. G. S.



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Net Worth and the Balance Sheet

CHAPTER I

NET WORTH

THE net worth of any business enterprise consists of the excess of the amount of its assets over its liabilities.

For example:

Total Assets.....	\$500,000.00
Total Liabilities.....	250,000.00
	<hr/>
Net Worth.....	\$250,000.00

In a statement of assets and liabilities the resulting balance is called net worth on the theory that if all of the assets of the business were sold for cash, and all of the debts were paid out of that cash, the amount remaining would constitute the real capital of the owners of the liquidated business.

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In other words, while a business man owns numerous assets in various forms, many of those assets may, and generally do, consist of articles of commerce which he has purchased, but for which at the time the statement is prepared he has not yet paid. Therefore, in order to ascertain how much of the cash and other assets in various forms really belong to him, he prepares a statement showing all assets in his possession and all liabilities for unpaid obligations. The balance, produced by subtracting the sum total of all of the liabilities from the assets, represents what he may call the amount of his own wealth or worth.

Since all assets constitute wealth, or worth, we might, from one point of view, say that a man is worth as much as the total value of all of the lawfully acquired assets in his possession, and this without regard to his liability to pay for such portion of those assets as were purchased on credit.

But this aspect of wealth or worth does not take into consideration the business man's relation to those from whom he has

purchased or borrowed wealth, so in business statements we do not rest satisfied with information concerning the gross wealth or worth. We deduct from the amount thereof the total of his debts and thus ascertain his net worth.

This process is referred to as producing theoretical results, because as a matter of practice no business is, or can be, liquidated and wound up with a resulting cash balance in hand exactly equalling the amount of the net worth shown in a balance sheet prepared prior thereto.

Valuation of Assets

With even the greatest amount of care and expert appraisement of assets, it is impossible to fix absolutely in advance of an actual sale the cash value of such assets as merchandise, machinery, or buildings. Until the exchange of such assets for cash has actually taken place, all calculations of value are but expressions of opinion, more or less accurate, according to the ability of the appraiser and his experience with what has happened in the

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past, on which he bases his judgment as to future happenings.

It will thus be seen how important it is that very careful estimates be made of all assets in the balance sheet. Unless the estimates are approximately correct, being neither very much too high nor too low, the business man may be deceived as to his real financial position.

Moreover, a record of his progress and increase in business is clearly indicated by the increase in the amount of the net worth shown on his balance sheet at the end of any given period, as compared with the amount shown on a similar statement prepared at the beginning of that period, due consideration being given to cash withdrawn from the business between closing periods in the form of profits. Thus the calculations of values become the more important to the extent that errors in under- or over-estimating his assets at the beginning or ending of a given period may create notions of his prosperity or poverty not existing in fact.

CHAPTER II

BALANCE SHEETS

WHILE a balance sheet of a merchant or manufacturer should represent his true financial condition, some of the accounts contained in the ledger from which the balance sheet has been prepared may undergo considerable change and adjustment before the assets represented by the accounts are transformed into cash or its equivalent.

A clear example is furnished in the aggregate of customers' debit balances, ordinarily styled "Accounts Receivable." Some of these debit balances may have been created by charges for merchandise ordered, shipped, and billed in the regular course of business, and yet the goods may not be accepted at billed value. Claims for errors or for damaged or under-graded goods may be set up before the account has been rendered to and accepted by the customer. Furthermore, the customer may fail to settle the account.

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For these and other reasons, it is clear that such accounts do not represent assets in the same way as do accounts representing the merchandise itself before it is sold. Unless sold for actual cash, the merchandise asset is first exchanged for a claim against the purchaser, to be again converted into a cash asset, when he finally pays for the merchandise.

If we keep fixed in our minds the fact that some ledger accounts represent claims in various stages of liquidation, as well as actual assets, it should be possible to so distinguish these that an understanding of the various items in a balance sheet will present fewer difficulties.

Form of Balance Sheet

The following is an ordinary form of balance sheet, such as is recommended by the American Bankers' Association to its members for use in obtaining statements of the financial condition of those applying for loans at their banks.

In this statement form the assets and lia-

bilities are shown in two columns—the assets in the column to the left and the liabilities in the column to the right—the total of the items in the asset column and in the liability column being equal each to the other. This form is used largely by bookkeepers and accountants in preparing written balance sheets on regular ledger paper. It frequently happens, however, that when the balance sheet is to be shown on the printed page there is not sufficient room for this form, and what is known as the report form is adopted. In this the assets appear in one group or set of figures, over the second grouping or set of figures which represent the liabilities. This, of course, is a mere matter of form; the particular way in which a balance sheet is stated being immaterial so long as all of the facts are truthfully represented.

Among English accountants it is the practice to reverse the form usually found in this country, the liabilities appearing in the column to the left and the assets in the column to the right. This arrangement is based upon the idea that the management charges

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itself with all of its liabilities and credits itself with its assets, while in this country the balance sheet is thought of as a list of debit and credit balances just as they are found on the ledger, and as the debit balances are shown on the ledger in a column to the left, and the credit balances in a column to the right, the same order is preserved in the preparation of the balance sheet.

SCARBOROUGH MANU

Balance Sheet,

Assets

Cash	\$26,843.90
Bills Receivable (net).....	7,752.84
Accounts Receivable (net).	111,172.08
Merchandise	224,323.82
Land	50,000.00
Buildings	189,934.93
Machinery—Fixtures	134,266.25
Reserve Fund Investments.	22,626.79
Other Investments.....	17,428.72
Miscellaneous ... \$900.00	
	120.85
	<hr/>
	1,020.85

Total Assets..... \$785,370.18

In order that the balance sheet recommended by the American Bankers' Association may be used by many different classes of concerns, it is necessarily very general and condensed. Only such accounts appear as constitute the main or chief accounts of the average concern, although many other accounts with different names may also be found on its books. The filled-in figures are

FACTURING COMPANY**December 31, 1911**

Liabilities	
Notes Payable.....	\$70,000.00
Accounts Payable.....	15,312.92
Deposits	3,026.67
Bonded Debt.....	100,000.00
Mortgages	5,000.00
Accrued Liabilities.....	1,177.09

Total Liabilities...	\$194,516.68
Capital	400,000.00
Surplus—Profits	82,436.50
Reserves	108,417.00

Total	\$785,370.18
-------------	--------------

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taken from a typical case, the name at the head of the balance sheet, of course, being fictitious. In the blank official form the names of the accounts are printed down the asset side to and including "Machinery and Fixtures." Below that are several blank lines in which for the purposes of the present consideration the accounts "Reserve Fund," etc., have been inserted. The liability side is given here as printed in the official form.

The statement as presented is in the form of a corporate balance sheet. The few differences between a statement of the net worth of a partnership and that of a corporation will be explained in later chapters.

In the chapters which follow, each item shown on the statement of the Scarborough Manufacturing Company is taken up in order, and the nature of the debits and credits which produce the balances set out against the named accounts is considered.

CHAPTER III

CASH

MOST of us are fairly well informed as to the paper currency and the gold, silver, and copper coins received and paid in the ordinary course of small tradings. The balance of cash in one's pockets is the result, so far as the handling of actual cash is concerned, of all one's previous cash transactions. Many of our personal instalments of income are received in the form of checks and coupons, as well as actual cash. The surplus over and above the amount needed for pocket expenditures is deposited in a banking institution of some kind.

So it is with a business concern. The cash balance, as shown on the Cash Book, is the difference between the receipts from all sources on the one, or debit, side of the book and the payments on the other, or credit, side. The balance between the receipts and payments is the exact amount by which the re-

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ceipts have exceeded the payments, and cash should be found in the possession of the concern to an amount equal thereto.

As a rule, a business man keeps little actual currency and coin in his office or store. Checks, money orders, and every other form of bankable funds received during the course of the business day, and all actual cash, excepting such as is needed for current expenses, are deposited in his bank.

In the example given, the cash of the Scarborough Manufacturing Company was divided as follows:

Cash in Bank (deposits).....	\$23,098.73
Cash on Hand (petty cash fund)....	500.00
Cash in Hands of Branch Managers	3,245.17
	<hr/>
Total	\$26,843.90

Cash in Bank

Cash in Bank means undrawn deposits in solvent banks, trust companies, with bankers, or in other depositories, payable by check upon demand.

It is difficult to frame a concise definition completely describing this asset. It would

appear unnecessary to insist that the amount said to be in bank must consist of the amount deposited, *less all checks issued against it*. With few exceptions, business men, bookkeepers, and cashiers understand and adhere to this principle, but in some few cases business men, in order to present favorable statements, affect to think that the actual amount standing to their credit on the books of the bank is the amount which they may consider as in bank, disregarding those checks which have been drawn and issued and sent to such distant points that in the ordinary course of events several days must intervene before they can return and be presented to the bank.

In one recent case of bankruptcy the treasurer of the corporation concerned had habitually drawn and issued checks to an amount greater than the balance to the credit of the company in his bank, depending upon his ability to collect funds and deposit them before the outstanding checks could be presented to the bank for payment. In other words, his bank account, according to his own check book, was continuously over-

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drawn, while on the bank's books the company apparently always had a balance to its credit. At least, it always had such an apparent balance until one day the treasurer was unable to provide the funds necessary to meet the incoming checks, and a bankruptcy was brought on which might have been avoided by stricter accounting and more businesslike methods.

It is much safer, and more honest, for a business man to consider that his bank balance has immediately been reduced by the amount of the checks issued, regardless of the time which may elapse before the checks are actually presented at his bank and deducted from his credit balance.

"Cash in Bank" usually includes deposits payable upon check or "order only after prior notice" of such intention, according to conditions under which the deposits were made, but if the amount is large and not available upon reasonably short notice, it would be better to set out the amount of such funds separately from the current checking accounts.

For instance, a manufacturer may have \$100,000 cash balance on which he is drawing no interest; he may find that \$50,000 is all that he needs for current working capital. In such case he may have the remaining \$50,000 transferred temporarily to another account in the bank on which interest may be paid to him, and the amount of this deposit be shown in a demand or time certificate of deposit. As a general rule, certificates of deposit, whether demand or time, are payable on demand. The time element merely defines the period during which the money must be left in order to draw interest. There may, of course, be other deposits the withdrawal of which must be preceded by notice, as, for example, in savings banks, where withdrawals may be made only upon order with a previous notice of such intention declared a week, two weeks, or thirty days in advance.

Frequently checks, drafts, and other negotiable instruments payable at distant places are received by the banks as deposits and credited at once to depositors, if in good standing with the bank, it being understood

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that these depositors will not draw against the uncollected credits. Strict banking practice calls for the withholding of credits for such instruments until collection is effected. In a financial statement, if the amount of such uncollected instruments is large, it should not be included in "Cash in Bank," but should be described as "Checks, Drafts, etc., for Collection," and entered on the statement as a separate item.

Cash on Hand

Cash on Hand means ready money in drawer or safe, in office or store, in branches or agencies; currency, coin, legal tender, or bank notes; also checks cashable on demand, money orders, or other instruments received as money, which in the ordinary course of business will be received by the bank as a cash deposit.

It does not include promises to pay money in the future, due bills, past due checks or checks dated ahead, promissory notes or memoranda of money loaned or advanced for any purpose. Such items, if of value,

should be stated under "Other Assets," and listed separately, if important; but if insignificant, included under the heading "Miscellaneous."

Actual cash in the possession of branch offices or stores may be included, but unsettled accounts of cash in the hands of agents or representatives to be accounted for when expended should not be included as "Cash on Hand."

Petty Cash and Imprest Fund

Ordinarily in a manufacturing business very little actual cash is required. Such as is needed for petty expenses which cannot conveniently be settled by checks is provided for by means of the Petty Cash fund kept in a desk drawer or safe.

Some concerns are accustomed to withhold from the deposits of the day, for petty cash purposes, a part or the whole of the currency and coin received—a practice not to be commended—while other concerns deposit in bank all cash in whatever form it is received.

Those who deposit every penny of cash in

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bank provide for petty cash needs by means of checks drawn on their bank accounts, and cashed. In such cases it is quite a common practice to charge on the ledger, through the cash book, the cash from the first check to Petty Cash account under a system known as an Imprest Fund, where the amount remains as a fixed fund. The amount of this fund is maintained thereafter by means of subsequent checks to equal the total of the depletions of the fund for expenses; the amounts expended being periodically charged to the proper accounts through the cash book. At any given time the amount on the ledger will be represented by actual cash and petty cash vouchers.

CHAPTER IV

NOTES RECEIVABLE

THE term "Notes Receivable" means negotiable promissory notes or accepted drafts received from customers in settlement for goods sold, not discounted, transferred or assigned.

Many people use the term "Bills Receivable," meaning the same thing as "Notes Receivable," but as some of these confuse "Bills"—meaning promissory notes received—with bills for merchandise purchased, the distinction is better preserved in the use of "Notes Receivable."

When a merchant or manufacturer sells goods to his customers, as a rule he expects to be paid within a certain time, fixed according to the terms of the particular sales or the general custom prevailing in his line of business.

Sometimes promissory notes are offered by the customer, either before or after payment

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is due by him for the goods purchased. If the promissory notes are accepted by the merchant or manufacturer the amount of these notes is usually credited to the customer in his ledger account and at the same time the "Notes Receivable" account is charged.

Discounting Notes Receivable

If the concern receiving such notes is provided at the time with sufficient working capital, it will retain these notes in its safe until shortly before they become due, when they are sent for presentation and collection to the place where, by their terms, they are made payable. In case it becomes convenient to obtain funds before the maturity of the notes, they are sent to the bank for discount; the bank discounting the notes by deducting from their face the amount of interest from the day of discount until the date set as the time for payment by the maker.

The notes thus disposed of are credited to the Notes Receivable account, the amount of the discount is charged to Interest and Discount account, and the difference between

the interest deducted by the bank and the whole amount of the notes, called the "proceeds," is charged to Cash.

There are other methods by which the discounting of notes is placed on the books, but this one answers the purpose of showing that, under the ordinary procedure, the balance of the Notes Receivable account always shows the amount of the notes on hand.

Notes received and subsequently discounted at bank should not be stated as an asset. The amount of such discounted notes remaining unpaid by the maker at the time the statement is prepared should be stated as a contingent liability in a footnote to the balance sheet.

In some methods of bookkeeping the notes which have been discounted are not credited to the Notes Receivable account according to the method already described, until actually paid by the makers. The general rule that such notes should not be stated as an asset must then be varied. It is correct as to principle, but under the method of accounting just referred to does not apply, as such notes

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are carried as assets with an offsetting liability.

When a promissory note is received from a customer the usual practice, as stated, calls for a debit to Notes Receivable and a credit to the customer of a like amount. Then when the note is discounted at bank, it calls for a credit to Notes Receivable of the full amount of the note and a debit to Cash of the proceeds received from the bank, and another debit to Interest and Discount of the amount of interest deducted from the face of the note by the bank.

For example:

Method A:

Cash, Dr.	\$940.00
Interest and Discount, Dr...	<u>60.00</u>
Notes Receivable, Cr.....	\$1,000.00

Under the other method referred to, the course is similar until the note is discounted, when another account is opened called "Notes Receivable Discounted" and the discounted note is credited to that account instead of to the Notes Receivable account.

For example:

Method B:

Cash, Dr.	\$940.00
Interest and Discount, Dr...	<u>60.00</u>
Notes Receivable Discounted, Cr...	\$1,000.00

Assuming that the Scarborough Manufacturing Company, whose Notes Receivable on the balance sheet amounted to \$7,752.84, had received other notes to the amount of \$20,000 not then due, but which it had discounted at bank, under method B the balance sheet would show as follows:

Under Assets:

Notes Receivable.....\$27,752.84

Under Liabilities:

Notes Receivable Discounted..... 20,000.00

This condition would be just as intelligible to the man who understands this method as the other method in which the amount of contingent liabilities is stated as a footnote on the balance sheet.

Following the process a little further, when the maturity date of the note discounted arrives, and the note is found to have

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been paid by the customer, a journal entry is made as follows:

Notes Receivable Discounted...	\$1,000
To Notes Receivable.....	\$1,000.

The object of this method is to have the ledger show at any given time the amount of customers' notes which have been discounted, but which have not yet been paid by the makers.

The only objection to be urged against this method is found in the fact that it places on the ledger a liability that is not, strictly speaking, the kind of liability that should appear there. This liability is that of the indorser of a note, and when such a note has been received for goods purchased by the maker of the note, the indorser is not liable unless the maker fails to pay it himself. It is a contingency which arises every time a note is discounted by the indorser to the extent that he may be compelled to pay back to the bank the money advanced by the bank on the note.

In a well-managed business, where the general business standing of the customers

is good, and their financial responsibility is established, it is but seldom that the merchant or manufacturer is compelled to pay the notes he has discounted, and, except in unusual cases, it is not necessary to maintain the Notes Receivable Discounted account, or to make the extra double entry in the books called for by this method.

"Good" Notes

Notes described as "good" should include only such negotiable instruments as are not due when the statement is prepared and which the merchant or manufacturer actually believes, after diligent inquiry, will be paid by the maker at maturity. Overdue notes should be stated in a separate amount under the description "overdue notes."

It is sometimes very hard to look upon the real value of notes in hand as being less than the face value. But in order that the statement of net worth may not contain any uncertain elements it is necessary to scrutinize this class of assets with care. We very often hear the expression regarding promissory

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notes, "They are as good as wheat," when a further inquiry reveals some doubt of the ability of the maker to settle his obligations promptly. Unless fully secured either by collateral or indorsement, or unless warranted by absolute knowledge of the financial responsibility of the makers or indorsers, Notes Receivable should not be appraised as "good" for the full amount.

This applies especially to "Notes Receivable" continuously renewed by the customers. Such notes should not be stated at face value unless amply secured by collateral or by indorsements. It is easy to see that if a debtor does not reduce the amount of his indebtedness within a reasonable time, he is not making good progress, and unless some turn in his affairs should improve his condition, his ability to meet his obligations may fade away.

CHAPTER V

NOTES RECEIVABLE (*continued*)

WRITTEN contracts or engagements not negotiable, to pay money, or for services or property, should not be included in *Notes Receivable*.

Nothing should be called Notes Receivable save legal negotiable promissory notes given to the merchant or manufacturer who is preparing the statement. All other contracts, rights, patents, processes, and evidences of property of more or less value to the concern, should be shown in the statement, but not under Notes Receivable.

Accommodation Notes

Notes Receivable given to the merchant or manufacturer for his accommodation should be stated separately and not as a part of the total of Notes Receivable from customers for goods sold.

Such notes are the same in effect as if

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made by the party accommodated and indorsed by the party issuing the paper, it being expected that the merchant or manufacturer for whose accommodation the note has been made will pay it at maturity regardless of his nominal position on the paper.

Any notes received in settlement or part settlement of previous charges on open account should be deducted from such accounts and stated as Notes Receivable. This is because the acceptance of the note changes the legal form of the claim against the customer from that of goods sold to that of note unpaid.

Some bookkeepers charge back to the customer's account a note received from him but not paid at maturity. For the same reason that a note is deducted from the open account, it should not be charged back when not paid. The mere failure in payment does not again transform the note into a claim for goods sold.

Sometimes when accounts due for merchandise sold are difficult to collect, promissory notes are accepted in lieu of the old

account. This further extends the time of payment, and in such cases the promissory notes may not be worth face value as an asset.

Notes Not in the Ordinary Course of Business

Notes received from officers, directors, partners, clerks, or stockholders should not be included in Notes Receivable, but should be stated in a separate amount.

Sometimes loans are made to those directly connected with the business, and memoranda, due bills, or promissory notes are taken as evidence of the loans, which are then carried in Notes Receivable account. While these may form legitimate assets, they should not be included in the account Notes Receivable, for the reason that such transactions are only incidental to and not part of the main purpose of the business. It may further be said generally that all facts not forming a necessary part of the business should be stated separately from those facts which are directly connected with and form part of the business itself. If this is not done the bal-

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ance sheet may lose much of its meaning and value.

Thus the fact that the Scarborough Manufacturing Company has on hand a small amount of notes received from its customers is one having some significance. If the actual amount of these customers' notes is obscured with miscellaneous obligations, it is more difficult to picture the business in its own entirety.

Notes Receivable given by subsidiary, controlled, or allied interests for merchandise should be stated separately from those received from outside customers.

Where one corporation owns or controls a number of other smaller corporations whose business forms part of the whole, the main company is sometimes referred to as the "parent" company and the other smaller companies as "subsidiaries."

Materials and finished manufactured articles may be transported from one to another of these subsidiary concerns, or from the "parent" to one or more, or from the subsidiaries to the parent corporation. Again,

advances of money are frequently obtained from the parent company by the subsidiary concerns. On the books of the parent company such debts of the subsidiary companies are sometimes clearly shown to be just what they are, but more often the notes given to the parent company are included as part of the Notes Receivable balance.

In some cases these notes represent cash advanced for construction purposes; in others, cash for current operating expenses; in others, the notes may represent goods or materials shipped which are either still on hand or which have been sold. There are as many different things for which these notes may have been given as there are ways of spending money. This uncertainty in itself renders the statement more difficult of understanding than it would be if all notes given by one allied or controlled concern to another operating under the same ownership were stated separately from its ordinary Notes Receivable.

So much for the clearness of understanding. There is another reason for separating

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these notes, of more importance in any consideration of the real net worth of a business. It may happen that many of these notes represent investments in enterprises which have turned out to be unsuccessful, and while the notes are being carried at full value, they are not represented by full value in the assets of the subsidiary concern.

In one concern whose statement was recently examined it was found that the Notes Receivable of one of the manufacturing plants were held and carried among the other ordinary promissory notes by the main organization to the extent of \$1,000,000, while the total capital stock of the subsidiary concern, all owned by the parent company, amounted to only \$100,000. The capital needed by the small concern, not only for construction purposes, but also for materials and labor, had been supplied by the parent company. Since the subsidiary company, at the time, was doing very badly, it was a grave question whether the assets of the parent company represented by these notes were of any material value.

There was no doubt whatever that the statement of Notes Receivable was misleading, containing as it did this large amount of notes representing anything but ordinary Notes Receivable from customers. It was misleading to the extent that without inquiry it would have appeared that the parent corporation possessed a much larger amount of what is known as "quick" assets than was actually the case.

Notes Assigned or Pledged

Any notes assigned or pledged as collateral for loans should be stated and the liability for the borrowed money shown as a liability.

Ordinarily business concerns having a credit standing are able to borrow such funds as are needed for temporary purposes upon their own promissory notes, which they discount at bank. But when they are compelled to offer security additional to that of their own established credit standing, they may take to the bank or banks, as collateral for these loans, such promissory notes as they have received from their customers.

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If such promissory notes have been received in the ordinary course of business from responsible concerns, and the date of maturity and places of payment are not far distant, it is quite within the ordinary for the holders to discount them at the bank, although it is generally regarded as better financing for business houses, wherever possible, to hold such notes until maturity, in the meantime borrowing for their requirements on their own notes.

But in many lines of business custom requires that settlements be accepted for goods sold, in long-term notes. In other lines the business is such that the sellers have to take many very small notes. In such cases the notes received from customers do not in themselves constitute very desirable loans from a banker's standpoint, and, as already suggested, money needed is obtained of the bank upon the concern's own notes, with these long-term or numerous small notes as collateral. When so taken, it is usual for the bank or banker to collect these collateral notes when due and credit the amount col-

lected to the Bills Payable of the concern borrowing the money.

For the sake of clearness, as has been said, the Notes Receivable taken from customers and pledged as collateral should remain as Notes Receivable on the books of the concern owning them, the amounts of payment being credited as reported by the bank.

For example:

Notes Payable.....\$1,000

To Notes Receivable..... \$1,000

Note J. Watkins, due December 31st, paid and applied to our loan at First National Bank.

In the balance sheet the amount of the Notes Receivable pledged should be set out in a separate item and designated as pledged, and the amount borrowed should appear as Bills Payable in the liabilities.

In the case of the Scarborough Manufacturing Company no such expedient was necessary. The aggregate of the Notes Receivable is small and the working capital owned and borrowed sufficiently large for its needs.

CHAPTER VI

ACCOUNTS RECEIVABLE

***A**CCOUNTS RECEIVABLE means the sum total of unsettled charges against debtors, usually for merchandise sold and delivered.*

When used in a general sense, this term may include any legal demand or claim arising out of verbal or written contract not evidenced by draft, promissory note, judgment, or mortgage of record.

In other words, an open book debit against any person may consist in part or in whole of claims against him which do not represent charges for delivery of the goods forming the main object or purpose of the business.

Examples may be given, such as the sale by a dry goods merchant of his horses and wagons, or by a manufacturer, of cutlery, of old machinery, etc., which, though proper enough charges, are not charges for goods manufactured or traded in.

When used in a more restricted sense, the term "Accounts Receivable" is usually understood to include only unsettled charges to customers for merchandise or manufactured product sold on ordinary trade terms, the right to collect which has not been transferred or assigned.

This restricted sense is that which is given to the usual customers' debit balances. In some retail lines the open book accounts are styled "Charge Accounts" as distinguished from cash sales.

In gas, water, and electric light and power company accounting the unpaid charges are usually styled "Consumers' Accounts" or "Due from Consumers."

Referring to the suggestion that Accounts Receivable should not include those accounts which have been transferred or assigned, perhaps it will be well to explain that sometimes merchants and manufacturers, finding it difficult to obtain sufficient accommodation for their financial needs at their banks, arrange with trust companies or bankers for loans on their bills for goods sold.

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When this is done the bills, instead of being at once mailed to the customers, are first taken in lots to the trust company or to the banker, and about 75, or even 80, per cent. of the amount of such bills is advanced to the merchant or manufacturer. The trust company or banker then takes possession of the bills and forwards them to the customers, first stamping them with a direction to the customer to remit, not to the merchant or manufacturer from whom the goods were purchased, but instead to the trust company or banker whose name appears in the stamped direction.

The business man obtaining money in this way should keep a careful record of the bills upon which his loans are obtained. The money received as an advance should of course be entered in his cash book as a charge to cash, with the necessary interest and commission adjustment, and the liability be credited in the proper book of record to "Loans on Assigned Accounts."

In preparing his statement of net worth when such loans are made, the amount of un-

assigned Accounts Receivable should be stated first, followed by the total face value of the "Accounts Receivable Assigned," each and all of which should be plainly designated on the ledger as assigned. As the accounts are paid to the trust company or banker and reported to the merchant or manufacturer, he should enter in his journal credits to his customers for the amounts collected, and at the same time enter debits or charges of corresponding amounts to the account called "Loans on Assigned Accounts." Thus at any given time the balance of the account will show the actual amount of the money owed to the bank, and the total of the "Accounts Receivable Assigned" will show the face value of those accounts assigned and not paid by the customers.

As used in the restricted sense, Accounts Receivable should not include money loaned or advanced to any person for any purpose.

In order that a business man may intelligently inspect his true financial position in business, he should not fall into the habit of carrying records of outside transactions upon

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his business books of account. Investments, loans, contributions to syndicates, or accounts with individuals for any one or more of a multitude of transactions which may give rise to charges on open book accounts, ought not to be mixed in with the accounts relating solely to the business of which the books purport to constitute a record.

If such outside transactions are recorded on his books he should set out such accounts separately from those representing the main business.

Good Accounts Receivable

When Accounts Receivable are described or appraised as "good," it is understood that the amounts included in the total so designated are (a) not yet due according to the terms of the sale and no information has been received creating doubt of the customers' responsibility and readiness to pay when due, or (b) are overdue, but experience with such customers in the past has been such as to warrant the reasonable belief that they will pay within a reasonable time.

The total of overdue accounts, especially after request or demand for payment, should not, as a rule, be considered worth face value in a carefully prepared statement of financial condition, but a deduction should be made for possible losses on collection.

In a conscientious effort to prepare an accurate statement of net worth, the debit balances or open book accounts with customers should be carefully analyzed. Of course no one can forecast the future action of any customer with absolute accuracy. Furthermore, customers who in ordinary times pay their bills regularly may be entirely upset in periods of business depression. Under such conditions, men believed to be absolutely reliable do such strange things that their probable course in any given transaction cannot be foreseen. At the same time, a thorough analysis of the open balances will throw much light upon accounts the value of which, considered as an aggregate without analysis, may be difficult to estimate.

Overdue Accounts

Taking the general terms of the trade, as

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well as any specific terms to certain customers into consideration, an analysis should be made of each account and the average date of the charges for unpaid merchandise ascertained. These accounts should then be classified according to age, as follows:

Analysis of Overdue Accounts

- Under 30 days overdue
- Over 30 days, but less than 60 days
- Over 60 days, but less than 90 days
- Over 90 days, but less than 6 months
- Over 6 months, but less than 9 months
- Over 9 months, but less than 1 year
- Over 1 year overdue

Careful examination should be made of those accounts appearing under the "overdue" headings, taking the terms of sale into consideration. No matter how much confidence a merchant or manufacturer may have in his customers, he cannot consistently claim as absolutely good, assets accounts found in the "over 90 days" column, which, by the terms, were due in 30 days from date of sale.

While in many individual cases he may be very sure that the customers will pay in time, yet on the whole the chances are unfavorable

that all of those falling within the delinquent 90-day class will pay the full amount of their debts. And so on, until he finds accounts over a year old, though due in 60 days from date of sale. He could not reasonably count on realizing the full value of all of such accounts unless he holds some security or possesses some special information regarding all the individuals in this excessively delinquent class, which would take them out of the general rule.

Many credit men are very suspicious of all accounts not paid for after 60 days from the promised day of payment. To throw out of asset valuation each and every such account would be just as unreasonable as to include all old accounts at their face value.

Careful inquiry of his clerks regarding the steps taken to collect overdue accounts will often lead the merchant or manufacturer to a definite conclusion, not perhaps that any account apparently good is absolutely worthless, but that, considered as an asset, he ought not to take it in his statement at full value.

CHAPTER VII

ACCOUNTS RECEIVABLE (*continued*)

ACCOUNTS *subject to discount, allowance, rebate, claims for damaged or imperfect goods, or known to be doubtful for any reason, should be deducted to the extent of the known or estimated shrinkage to occur in final settlement.*

Of course, all known bad debts should be closed out and charged to the Profit and Loss account. Those accounts not known to be bad or even doubtful, which on their face are delinquent, and thus, according to general credit knowledge, not worth face value, should be partially offset by means of a reserve set aside from the profits for bad or doubtful debts.

It is customary to charge off bad debts, and close the accounts of those from whom it appears impossible to collect the amounts due. It sometimes happens, however, that changes in circumstances make it possible to

collect accounts subsequently which appeared worthless at the time they were charged off. A separate book or ledger should be kept containing records of all bad debts. This book should be frequently scrutinized that known changes for the better in any of the old debtors may not be overlooked.

Unsettled Charges

No unsettled charges against any individual connected with the business, either as a proprietor, stockholder, officer, or clerk, whether for overdrawn salary accounts, expense accounts, unpaid stock subscriptions, or for any other reason, should be included in Accounts Receivable, but should be stated separately.

It is frequently observed that overdrawn salary accounts are carried in the Accounts Receivable as balances due from the officers or clerks who have overdrawn; and in some cases partners maintain open drawing accounts indefinitely, including the debit balances in the same class as balances due from customers.

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Again, large advances of cash are sometimes made to agents or salesmen either on account of salaries or commission, or for expense funds. It would seem needless to say that such accounts are not Accounts Receivable in the understood sense of the term, if it were not for the fact that some business men and bookkeepers include all open debit balances against individuals in this one class.

Collecting Accounts Receivable

The elimination from Accounts Receivable of every kind of debit charge other than for goods sold, is useful in more than one way. Besides the assistance rendered in determining the net worth of a business, the amount of outstanding debit accounts for merchandise sold, taken into connection with the volume of sales, throws light on the financial ability of the management—a light which should be of help to the management in correcting the weaknesses disclosed.

After learning the terms of credit on which goods have been sold, a simple computation based on the terms of credit, volume

of sales, and the amount of Accounts Receivable, will show whether or not the collections have been made promptly. For example, the Scarborough Manufacturing Company sold during the year 1911 an aggregate of \$680,000 on various terms of credit, the average of which would be about 45 days. The amount outstanding was approximately the same at the beginning as at the end of the year, i.e., \$111,172.08; whereas the Accounts Receivable, if collected according to the terms of credit, would amount at any one time to not over, approximately, one-eighth of the total sales, or about \$85,000.

The actual amount of the Accounts Receivable is therefore about \$25,000 greater than the average term of credit would indicate as necessary.

Of course this rule must not be taken as a basis for final judgment without further inquiry, but on its face the Scarborough Manufacturing Company's collection department has been too easy with its customers for its own good.

Not long since, the annual sales of each of

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two concerns in the same line of business aggregated about \$1,000,000. One concern carried \$400,000 of Accounts Receivable, while the other succeeded in keeping its customers' accounts down to only \$200,000, or 100 per cent. less than the more easy-going concern. As a result the first was obliged to borrow heavily and pay interest on the amount borrowed—a tax on the business which would not have been needed if it had collected the accounts due to it. Besides this, the danger of loss through accounts grows with the length of time the accounts are allowed to remain uncollected.

Accounts Receivable from Allied Interests

Accounts Receivable representing unsettled charges against subsidiary, controlling, or allied interests should be stated separately.

Many interconnected companies buy of and sell to each other, piling up large Accounts Receivable and Payable, which are not of such character as to be properly included in the same class as accounts due from

outside parties. In some cases, of course, the concerns, though controlled, are sufficiently distinct to permit transactions between them to be regarded as similar to those of entirely separate concerns. But in many instances the charges for goods delivered by one of the subsidiary concerns of a large corporation to another of the concerns amounts to nothing more than a transfer of materials or merchandise from one plant to another.

Where commission merchants having merchandise in their possession owned by manufacturers, advance funds to the owners of the merchandise in anticipation of sales, the amount advanced should not be included in Accounts Receivable. Such advances should be separately stated and described as "Advances of Cash Against Merchandise in Our Possession for Sale on Commission."

CHAPTER VIII

MERCHANDISE

***T**HIS account in a balance sheet is intended to mean unsold marketable goods and wares owned by a merchant and bought for sale, these goods being of any kind falling within the general purpose of his business.*

Reference is made here to the merchandise of a merchant or trader. The finished product of a manufacturer is described in a later chapter.

Valuation of Merchandise

With certain exceptions, the inventory value of merchandise should be based upon purchase price plus freight charges, and, in some cases, expenses incident to carrying the stock.

Some merchants and manufacturers calculate the inventory at full selling price, or at selling price less certain discounts, but ex-

cept in a few particular cases this method is not in accordance with the best business principles.

According to the views of such merchants and manufacturers, the moment goods are bought or manufactured and ready for sale, a value attaches to them corresponding to the demand of the consumers. The price which the purchaser is willing to pay for the goods constitutes that value, they argue, and that price is the amount at which the merchant should be allowed to appraise his goods in stock.

On the other hand, until the goods are actually sold and accepted by the purchaser, the goods actually belong to the merchant or manufacturer, although it is true that cases exist in which the legal phases of the contract between the vendor and vendee produce conditions whereby it would be perfectly justifiable for the merchant or manufacturer to value his goods at full price.

Again, there are lines of business in which the articles dealt in are constantly fluctuating in price, due more or less to the speculative

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value of the article, as, for example, flour and cotton.

Such cases may form exceptions to the general rule and must be considered carefully, but if a valuation on merchandise is fixed above cost, the result, according to the ordinary methods of bookkeeping, will be a showing on the books of a profit not yet earned.

By "not yet earned" is meant that the goods have not yet been actually sold and accepted. Up to that point the goods belong to the merchant. When the goods have been sold and accepted, the asset is changed from the asset "Stock on Hand" to an asset consisting of a claim against a supposedly responsible party. That change in the legal status seems to form the most appropriate marking point for the taking on the books of a profit.

In some lines goods are ordered by the purchaser six months in advance of delivery. In such cases it would seem that at inventory time such goods as are on hand, having been manufactured on order, should be valued at selling price less expenses of carrying

in stock and delivery to the point agreed upon. This method seems to be correct on the principle that the goods actually belong to the purchaser, and since he is bound to take and pay for them, the profit to the manufacturer has already been earned.

In the exceptional cases referred to, such would be the fact, and such a method of treatment would be correct, but the cases are comparatively rare in which the goods, though still in the manufacturer's actual possession, have in law been delivered to the customer and are simply held, subject to his order and at his own risk.

A fairly accurate test of the matter in each case may be applied in the form of this question: "In the event of destruction of the goods by fire, on whom would fall the loss?"

If the answer is clear to the effect that the customer would be the loser, the manufacturer is justified in considering the goods as sold. If, on the other hand, under the terms of the contract of sale, the goods, though ordered and manufactured, are still the property of the manufacturer to the extent that

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their loss or damage by fire would fall on him, he is not justified in considering them sold. Cancellations may come in before delivery and after delivery the goods may not be accepted.

By whatever means effected, delivery, either actual or constructive in law, must be made to the customer and the goods be accepted by him as to price, quantity, and quality before their ownership passes.

When, however, the cost of the merchandise at inventory time for any reason exceeds the market value, the latter should form the basis of the valuation; the reason being that the inventory at cost compared with market value shows a known loss, which should be deducted from the value of the merchandise at once.

A frequent instance of overvaluation is found in merchandise which was once salable, but which has become worn, or out of style. Such articles are sometimes carried in stock under the heading of "discontinued numbers." Whatever the reason for their depreciation in value, articles of merchandise

not worth what they cost should not be carried at more than their real value.

The exceptional cases in which the general rule as to valuation does not hold are those wherein the nature of the business is such that the market or selling price furnishes the most practical basis for the true ascertainment of the financial position of the merchant.

Manufacturers of paint and linoleum seem to furnish instances of this kind. The controlling ingredient in the manufacturing of these articles is linseed oil, the price of which varies considerably, according to numerous factors which affect the market price. At the end of the year 1911 the price of this oil was about seventy-one cents per gallon, while during the year the average cost was eighty-five cents per gallon. This condition in the linseed oil market during the year produced a cost above market price at the end of the year for such articles manufactured from the higher priced oil as were then on hand. In many cases at the end of the year paint and linoleum concerns reduced the inventory

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valuation of finished goods to a basis of the price of oil at the time the inventory was taken.

But suppose the price of linseed oil was considerably higher at the close of the year than it had been during the year. Would the manufacturers be justified in increasing the inventory valuation of finished stock to agree with the higher priced oil? The justifying argument advanced by some in support of this course is that if the sales for the next year are based upon the actual cost price of oil during the preceding year, a loss would occur which would not be incurred if the inventory of manufactured goods at the close of the year was based upon the cost of oil at the end of the year.

This argument is used by those who think of the cost of an article as having a necessary relation to the selling price, and that the cost once found may be used for a year in advance. This idea confuses the actual cost of manufacturing in the past with estimates on which prices are fixed in advance for future sales.

While actual cost records should be consulted very carefully in making up schedules of present or future prices, it must be remembered that the cost figures are obtained from past happenings and may not be safely relied upon as the sole guide for future costs or prices.

When the price of an article is made and the cost price must enter into the consideration, each item of the latest cost record of that article should be examined in the light of later knowledge of market and labor conditions and probable future conditions, so that the future cost may be estimated as nearly as possible in accordance with anticipated future happenings.

Looking at costs and prices from this point of view, it will be seen that the inventoried cost of an article at the end of the year may be taken at actual cost, or market price if that is lower than cost, and the estimates on which prices for the following year are based may, without inconsistency, be taken at entirely different or even purely supposititious figures.

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Therefore, even in the case of oil, higher priced at the end of the year than the average price during the year, the rule of taking actual cost when lower than market value would not only be sound, but would at the same time be in accordance with conservative management, and, as has been seen, it need not conflict with subsequent price-making.

Merchandise on Hand

Merchandise on Hand should include all merchandise actually in the merchant's store or warehouse, or out on approval, and all merchandise purchased by him, not yet delivered, but which he must receive and pay for; but it should not include merchandise ordered but not received or accepted, which by the terms of the purchase he may cancel before delivery, or refuse to accept upon delivery.

Any merchandise pledged for loans should be stated separately from the amount of merchandise unpledged, and the liability for the borrowed money should be shown as a lia-

bility. Frequently concerns handling merchandise of considerable value are able to obtain loans upon the pledge of that material as collateral. Sometimes the merchandise is placed in the actual possession of the bank loaning the money, but more often the evidence of its existence is in the form of warehouse certificates or bills of lading.

Any merchandise held for sale on consignment, or in trust for any purpose, not absolutely owned by the merchant, should not be included in the inventory, which is intended to show only such materials or merchandise as is owned.

CHAPTER IX

FINISHED PRODUCT

***F**INISHED PRODUCT means unsold completely manufactured marketable articles made and owned by a manufacturer and in his possession at his factory or mill, or at warehouses or branches or agencies.*

In other words, this means the ordinary goods produced by the manufacturer and ready for sale.

It will be noted that a distinction is made between the merchandise of a merchant and the product of a manufacturer. This is a distinction which indicates that merchandise is bought and sold by merchants, while the finished product represents materials bought and labor expended in producing the articles manufactured. The finished product of a factory may consist of merchandise ready for the final consumer, who purchases it from the manufacturer direct or from merchants.

Some manufacturers accommodate their customers by supplying articles not manufactured by them, but which are traded in or used by customers buying the main articles manufactured. An example is found in a paint company which manufactures nothing besides paints, but which carries a small stock of brushes, sand paper, glass and similar articles for the accommodation of its customers. In such cases the inventory should be classified so as to show the total of the raw material, the partly finished and finished product, and also the merchandise purchased from others for use in supplying customers.

Manufacturing Cost

The valuation of finished product should be based upon cost, including a proper proportion of the expenses of manufacturing and caring for the stock to the time of inventorying.

Just what expenses may properly be added to the manufactured product of a factory to determine its cost cannot be enumerated.

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and described in detail in such manner as to establish an exact rule for the guidance of all manufacturers. In general it may be said that the manufacturing cost of a finished article is intended to include all items entering into the cost of production, such as materials, labor and overhead factory expense. Manufacturing cost does not include any part of the cost of advertising and selling. It should include the cost of that portion of the general administration devoted to producing, but no portion not strictly chargeable to manufacturing.

Perhaps the distinction between what may be included in manufacturing cost and what may not will be clearly marked in the item of Bad Debts, which represents loss due to error in judgment of the salesman or credit man or both, or to unfortunate turns of events which could not have been foreseen at the time the credit was granted.

Whatever the cause for the loss on Accounts Receivable for goods sold, delivered, and accepted, the manufacturing branch of the business cannot be charged with fault.

If it cannot be charged to the factory, by the same reasoning such items do not constitute part of the manufacturing cost, and thus cannot be added as a manufacturing expense to the valuation of the inventory.

Briefly, the manufacturing cost attaches to the product up to the time the goods are ready for delivery and have been sold. A distinction might be drawn between the actual cost of manufacture and the expense of storage up to the time the goods leave the factory, but while the cost of carrying might seem at first blush to constitute storage cost as distinguished from manufacturing cost, an argument on the other side to the effect that in many lines goods cannot be sold unless made up and kept ready for sale, would narrow the storage idea to a line too fine for practical purposes.

In some lines of business goods are manufactured upon orders considerably in advance of the time set for delivery. At inventory time many business men, considering that the ordered goods have been sold, put the entire selling price on such of these

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goods as have not been delivered. Unless the buyer has actually inspected and accepted the goods, they have not really been sold, and until they are really sold the manufacturing cost only should be used as a basis for valuation.

Consigned Goods

Finished Product should include all articles shipped on consignment for sale and accounting to the owner. Some manufacturers include the charges for such consigned goods in the Accounts Receivable, but these charges do not consist of actual sales, and the statement should show what in reality is a fact, that certain articles of product owned by the manufacturer have been shipped to consignees for sale and accounting for the proceeds of the sale.

There are certain contracting enterprises which do not fall under the head of manufacturing, where deviations may or must be made from this general rule. An explanation of the special accounting terms used by such concerns is not included in the present

consideration, which is restricted almost entirely to the terms used by merchants and manufacturers engaged in the ordinary lines of business.

CHAPTER X

PARTLY FINISHED PRODUCT

PARTLY finished product consists of articles in process of manufacture at the time the inventory is taken, which are intended to be completed and become finished and salable stock in the ordinary course of the business.

Such partly completed articles should be valued at cost of labor and material, plus a proper proportion of the expenses of the business to the time of inventorying, as explained under the description of finished stock.

In some lines of manufacture it is comparatively easy to estimate the cost of goods partly finished at the time the inventory is taken. In other lines it is exceedingly difficult to estimate the amount of labor, material, and general manufacturing expenses which have been absorbed in the course of manufacturing the articles not yet fully fin-

ished. Where the total of such articles would, if correctly inventoried, form an important bearing upon the net worth, manufacturing plants cannot well do without some form of cost accounting which will show the cost of the manufactured product in every stage of its progress through the factory, from raw material to its finished state.

It may be simple to estimate the amount of material and direct labor, and even direct expense, consumed in a partly finished article, but the distribution of indirect or overhead expense—i.e., such expenses as cannot be easily identified with any particular object of the many produced—presents a much more difficult problem. Some adequate plan must be provided for this, or otherwise the application of such expenses at the time of inventorying is likely to lead to misrepresentation in the accounts.

The Perpetual Inventory

Contrasted with the difficulty which every manager who does not have a cost system experiences in placing the proper valuation on

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partly finished articles is the comparatively simple problem presented to the manufacturer whose cost records are carefully planned and can be safely used in obtaining inventory values. In some concerns the amount and cost of every article in stock, whether fully or partly manufactured, can be readily ascertained at any time. Some, indeed, maintain a perpetual inventory of all supplies, materials, goods in process of manufacture, and finished product. In such cases the actual inventory of unfinished product consists merely of the verification of its existence.

For this purpose a list of the unfinished articles shown by the records to be in existence in various stages of manufacture in the different departments of the factory is prepared, and the actual weighing and counting is undertaken merely as a proof of accuracy, in much the same way that a cashier counts his cash in confirmation of the cash balance shown in his cash book.

Ordinarily, when information is wanted as to the amount of cash on hand, it is not

necessary for the cashier to go to his cash box and by actual count assure himself of the contents. An actual count is undertaken, of course, with sufficient frequency to prevent mistakes in his actual cash, but for general purposes he may safely rely upon the balance supposed to be on hand as shown by his cash book.

In the same manner, properly planned and maintained cost accounts should at any time produce the most satisfactory information as to the quantity and cost of not only the raw materials and finished stock, but of the amount and cost of the goods which have not yet reached the completed state.

Parts of articles made up in advance of actual assembling into the finished product should be inventoried at cost, plus in some cases a proper proportion of general expenses to time of inventorying as explained under Finished Product.

In some lines of manufacture the product consists of complicated machinery or other articles, the completion of which calls for the assembling of more or less numerous

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parts, which have previously been manufactured and placed in the store-room awaiting an order for the assembling.

A proper system of accounts will produce the cost of each one of these parts so that when assembled the total cost of the completed article may be determined, and in the meantime the cost of each and every part may be readily ascertained.

CHAPTER XI

RAW MATERIALS AND SUPPLIES

THE term Raw Materials means unconsumed materials purchased and owned, to be used in the manufacture of the finished product of the manufacturer.

Raw materials in the elementary sense mean nothing more nor less than earth products, such as clay, ore of various kinds, and timber. But as used in the ordinary sense all materials are raw materials, whether in the raw state or partly finished, bought for conversion through labor into another state. For example, brass pipe already manufactured is raw material for metal bed manufacturers, and sheet paper is raw material in the manufacture of books.

The valuation of raw materials should be based on the cost, plus freight, and a proper portion of expense of carrying in stock until used.

Materials not adapted to the present

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shapes, styles, or quality of the product should not be included at higher than scrap value.

Inevitably in any manufacture, as the shape and style change from year to year, the stock of raw materials will contain more or less out-of-date material, worth no more than scrap value. Careful scrutiny of this stock should be made by the business man who does not wish to deceive himself regarding his real net worth.

Much of this loss on materials may be prevented if current watchful vigilance is exercised by the manager. An unnecessarily large stock should not be carried. Old material should be used up as far as may safely be done before new is purchased. This rule is not always observed. It not infrequently happens that requisitions are made by foremen for certain sizes and shapes of material which do not happen to be on hand, and such stock is ordered immediately by those having charge of the purchasing of material, when the needs of the foremen might be accommodated to the stock in hand, and by

this means its volume be kept down to actual needs.

Supplies on Hand

The item Supplies on Hand means unconsumed articles in stock, to be used in the operation of a factory or mill, not entering directly into or forming part of the finished product itself; fuel, oils, repair parts or materials, and packing are examples of supplies.

Supplies, as the term is ordinarily used, means certain kinds of materials which must be used by every factory in keeping the plant in running order. This sort of material does not become a part of the manufactured goods, and in carefully planned accounting systems, records of such supplies are kept separately from material consumed in the manufacture of the product. The amount should be kept down to the minimum actually needed. The same caution is required to prevent overloading of supplies as is needed to prevent too much stocking-up of raw materials.

The valuation of supplies should be made

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on the basis of cost plus freight, unless, of course, the prices of the supplies have dropped below the original cost, when the same rule applies as to merchandise. To the cost may be added a proportion of the expense of handling and storing.

Any worn-out or obsolete article should be included in the inventory at no higher than scrap value.

CHAPTER XII

REAL ESTATE

I***N*** *general, the term Real Estate includes any interest in lands. A more restricted use excludes all other interest than actual ownership in fee of such land and buildings as are used in the operation of the business.*

Real Estate should be valued at cost, less depreciation. There are cases in which the value of the land increases to an extent sufficient to offset the depreciation of the buildings, and there are certain cases in which the merchant or manufacturer would be warranted in increasing the amount at which the real estate is carried on his books, but in business circles it is a general rule that such increase should not be placed on the books.

Logically, there is no reason why the book accounts representing assets should not be "written up" where book values are below actual values. If a manufacturer "writes

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down" the book value to provide against possible depreciation, he ought from every consideration of pure reason be allowed to write up his assets when their value exceeds the book value. In other words, if an adjustment of book values to correspond with facts is to be commended, the rule requiring such adjustment ought to work both ways, up as well as down.

As a matter of practice, while many cases of "writing up" are not founded on facts sufficiently established to warrant it, there are cases in which the writing up is not objectionable. If the method of bookkeeping employed calls for adjustments up and down in definitely expressed accounts, the "appreciation" of value would not constitute an addition to the asset account itself, but would call for the opening of another asset account, called "Appreciation of Real Estate," with a corresponding surplus account, probably called "Real Estate Appreciation Surplus."

This suggestion is in accordance with the opposite principle of depreciation by which all plant accounts should be kept in such a

way as to show actual cost, with any estimated depreciation shown separately as a reserve account.

If the merchant or manufacturer occupies his premises as lessee, he should not include the lease in real estate, but should state the amount or value of the lease, if of a long term and valuable, separately.

If the building is leased under terms by which the tenant is obliged to pay for all improvements, any large outlay may be stated in the balance sheet under the heading "Improvements," care being taken to write off enough annually to reduce the amount to the minimum at the end of the lease.

On the balance sheet of the Scarborough Manufacturing Company the real estate is separated into two accounts—"Land" and "Buildings." It is of advantage to those who examine statements to have these items shown separately. When this is done, a better idea of the equipment as a whole and as to its separate parts can be obtained and a better estimate of the amount of deprecia-

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tion can be calculated; the depreciation on buildings from a manufacturing standpoint having little relation to the rise and fall in the value of land.

If land and building can be stated separately, the cost of each should be shown, together with the amount of depreciation to the date of making the statement. The amount of depreciation should be shown as a reserve. The assessed value of the real estate and the market value should also be stated in a footnote.

CHAPTER XIII

MACHINERY—FIXTURES

M*ACHINERY as applied to a manufacturing plant means all plant equipment owned, other than buildings and land; engines, boilers, shafting, belting, generators, machine tools, small tools, appliances, and instruments; such machinery or mechanical devices as are used in the operation of the mill or factory.*

Many manufacturing concerns do not include in the plant inventory small tools such as hammers, files, saws, chisels, shovels, and wheel-barrows. Such tools, if subject to constant use, usually wear out rapidly and frequent purchase of other tools is required, the cost of which is charged to the expenses of operation and not to the plant account.

There is no objection to this plan, nor, on the other hand, is it objectionable to include in the plant inventory and carry on the books all small tools at a lump sum fairly repre-

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senting the value of such tools as are required to be on hand at all times. The amount of the ledger account need not change unless the number and value of the small tools change materially. Under such circumstances all renewals of worn-out tools may properly be charged to maintenance of the plant as an operating expense.

Valuation of Machinery

The valuation of machinery should be based upon cost, with the proper deductions for depreciation, and, if buildings are not owned, with due regard for the terms of lease.

Appraisal companies, when asked to appraise machinery, usually attempt to fix a valuation thereon which they describe as the "reproduction" value at the time the appraisal is made. For example, if a machine was purchased many years ago at a cost of \$1,000, and at the time the appraisal was made could not be duplicated as a new machine for less than \$1,200, the latter amount would be used, to which would be added an

estimated amount to represent cost of freight and installation.

From the "reproduction" value is deducted the estimated amount of depreciation on the old machine as it stands at the time the appraisal is made. If carefully estimated, the total of the inventory and appraisal thus produced represents the estimated amount which would be required to reproduce the machinery in the condition found at the time the appraisal was made.

If the amount so found is kept in a separate book and used only for fire insurance purposes, the method is, if carefully executed, reliable enough for that purpose. If, however, the amount so found is placed upon the books, it sometimes causes a "writing up" of the machinery accounts and produces a surplus not justified, on the mere assumption that new machinery would cost more to-day than formerly.

Wherever possible, it is safer for the management of any business to maintain the machinery account at cost, providing for depreciation by proper charges to the operating

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expenses and corresponding credits to a Reserve for Depreciation account.

There can, of course, be no argument against the conservative adjustment of book values according to established facts, but if machinery values are adjusted and readjusted according to the opinion of successive appraisers, an unreliable balance in the machinery account is likely to result. Furthermore, such ups and downs of the machinery account may produce deceiving effects upon the surplus account.

If, on the other hand, the original cost of machinery is adhered to, with deductions for worn-out machinery and additions for new machinery, the balance of the account always means something definite. It means that every article of machinery in use at any given time is represented in the machinery account at its original cost. The offsetting account where the wear and tear of the machinery is provided for is, of course, the reserve account, which will be more fully described in its own chapter.

Machinery Inventory should not include

obsolete, dismantled, or worn-out tools or appliances at higher than scrap value.

Sometimes machinery of special kinds is purchased to be paid for in instalments. If the full value of the machine is stated as an asset, the amount of the unpaid instalments should appear in the liabilities.

Where buildings are not owned, a careful inventory of machinery actually owned by the manufacturer should be made, and a definite understanding between the owner and tenant should be reached as to just what may be removed by the tenant as his property at the expiration of the lease.

CHAPTER XIV

FURNITURE AND FIXTURES

F*URNITURE and Fixtures, as usually understood, means articles of ordinary or special use needed by a merchant or manufacturer to display his stock of goods or samples, afford conveniences to his customers and clerks, and record his business transactions.*

Ordinarily the term includes many articles, such as, for example, show-cases, desks, racks, shelves, chairs, typewriters, and sometimes electric lighting systems, sprinkler systems, partitions, and all improvements not forming part of the building as a building.

The furniture and fixtures should be valued at cost price, less a proper deduction for depreciation.

If the building is owned by the merchant or manufacturer, Furniture and Fixtures may include all the various articles usually so designated, whether separate from or at-

tached to the floors, walls or ceilings, such as elevators, and sprinkling, heating and lighting systems; but if the building is not owned by the merchant, in inventorying and valuing the furniture and fixtures due regard should be given to the terms of the lease.

CHAPTER XV

OTHER ASSETS

THE ordinary statement forms provided by banks for the preparation of statements, by their customers are usually very much condensed and provide no special spaces for assets, save those which have been described. Where other assets are to be listed, the term "Other Assets" is frequently used with a blank space or two for the separate listing of important items.

In a business of ordinary character, the items which cannot be properly placed under any of the more specific accounts will not be numerous or important, but there are exceptions to this general rule. In such exceptional cases all the important assets of the business should be listed and described separately.

Horses, wagons, and harness may be of sufficient importance to list separately, in which case the amount should be shown at

cost with proper deductions for depreciation, or at an appraised value.

Funds in the hands of foreign banks and investments of surplus capital in stocks and bonds may be shown under this general heading, as well as investments of sinking, insurance, or other special funds.

If large, each of these separate assets should be described and the amount shown.

Investments in the stocks and bonds of subsidiary or affiliated enterprises, advances for cash to such enterprises, or charges for goods delivered to them, should be listed here.

Treasury Stock

Frequently in corporation statements an item called "Treasury Stock" appears as an asset. In some cases the amount represents an asset of the corporation. This is so when the corporation, having issued its capital stock, acquires portions of it for resale. In other cases the so-called Treasury Stock represents merely that portion of the authorized capital stock which has not been issued. In

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the latter class of cases the amount of such unissued stock is erroneously entered at par as an asset and the total authorized capital is entered among the liabilities. A corporation is liable to account to the shareholders for only such capital as has been contributed by them, and therefore the real capital liability can only be the amount of shares actually issued and for which payment has been made.

There are, as stated, cases in which its own stock may be acquired by the corporation and become real Treasury Stock. As a rule, capital stock may be issued only for money, property, or services rendered, and it can only be issued at par value for the assets acquired or services rendered. After it is once issued to shareholders and afterward lawfully reacquired by the corporation by purchase or by donation, it becomes the property of the company and may be sold for any price above or below par. This stock is Treasury Stock in the proper sense.

Business Investments

Merchants interested in producing com-

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panies will frequently hold stock, bonds, or other assets of various kinds in the concerns for which they act as distributors. As an illustration, many wholesale lumber firms own lumber mills at points distant from their own yards or offices; also timber tracts for the purpose of acquiring lumber for sale. Care should be taken to describe these holdings, so that it may be seen just what interest the firms have in the mills, and whether the tracts are actually owned or whether the ownership includes merely the stumpage rights. All such items should be so described that the exact nature of the right or title may be clearly seen.

Valuation of Patterns

Under the head of "Other Assets" also fall the items of patterns, patents, trademarks, good-will, copyrights, cost of secret processes, formulæ, and stereotypes, the valuation of all of which requires special thought and skill.

The first of these assets, patterns, is one the valuation of which has caused much dis-

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cussion, not only where special castings are made in foundries belonging to the concern, the castings forming one stage only of the process of manufacture, but as well in foundries where no other business is carried on besides the manufacture of general castings for other manufacturers.

In one case it was found that a concern had been carrying a very large number of patterns at full cost value for years, although orders for but few of the castings had been received during that time. In an effort to ascertain the probable value the books were examined for sales. One gear wheel pattern was found to have been unused for over two years, while six of the wheel castings had remained unsold in stock during all of that time.

When the expense of making patterns has to be borne by the foundryman, it is hard for him to make up his mind that the value of patterns is very little if the customers do not repeat their orders within a reasonable length of time. What is a reasonable time depends, of course, upon the circumstances

in each case, but it is much the safer policy to write off the cost of the patterns rapidly until the asset value of such of them as are not in actual use is reduced to a nominal amount.

In some lines of manufacture where large varieties of castings are required to produce the articles manufactured, the patterns are valued under general rules more or less rigidly followed by manufacturers in such lines. A rule observed by some manufacturers is that patterns shall not be carried on the books at a greater value than an amount equal to 10 per cent. of the average yearly sales for the three years preceding the date of valuation.

Another rule calls for the writing down of patterns 50 per cent. the first year and 25 per cent. the second year, at which time an appraisement is made and the pattern valuation adjusted on the books.

Another more general rule calls for the establishment of an arbitrary lump sum at which patterns are carried on the books, all expense for patterns during the year in ex-

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cess of that amount being charged off at the close of the year.

No general rule adopted by others may be safely followed by any manufacturer. The manager of each foundry and each factory of every kind in which patterns of one description or another are used should study the problem for himself, not leaning too strongly in favor of the thought that some day little-used patterns may be valuable; nor, on the other hand, leaning too much the other way in favor of reducing the value to a merely nominal sum. Good patterns in a going business possess considerable value, not only because of the reduced cost of repeat orders but, in addition, because the time saved in reproduction will in itself attract customers, who, in the case of a general foundry, may be in urgent need of castings made from the patterns, or in the case of a factory, may be in need of the manufactured articles of which the castings form a part.

There is perhaps no better way to arrive at the value of patterns than by a careful inventory at the end of each year, and an ap-

praisement. This should be made by those of the management who may be relied upon to be conservative, and take into consideration all of the conditions of the business, the part which each pattern plays in the sales, and the prospects of future orders.

Valuation of Trade-Marks

Trade-marks and brands should not be placed upon the books as assets unless purchased from another concern. The actual cost of obtaining original protection of such things is too small to become an expressed asset of the business. Where the business has been incorporated and the trade-marks or brands have been acquired by the company from the former owners, it is perfectly proper for the new owner to enter these items as assets on the books at the purchase prices. Afterwards, serious consideration should be given at each closing period to the book valuation as compared with the actual value.

A steel specialty manufacturer has spent considerably over \$1,000,000 in advertising his trade-name and trade-mark, and there-

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fore carries the trade-mark on his books at this valuation. He has been successful and could well afford to diminish this amount by writing off freely from it each year for several years without materially reducing his book profits. But his view is that the trade-mark is worth \$1,000,000 and should so show on the books. In this case, being the principal owner of a wealthy concern and the party principally interested, no one can seriously question his judgment. If, however, the amount of the trade-mark asset was essential in his statement in order to produce a surplus or net worth, the actual value would be brought into serious question by an examiner for credit purposes, or by any one verifying the net worth of the business.

In the case referred to the proprietor is mistaking the value of his trade-mark for the value of his good-will, taking everything connected with it into consideration. It is very doubtful whether any one would pay \$1,000,000 for the trade-mark separate from the business, its organization, plant, and management.

CHAPTER XVI

OTHER ASSETS (*continued*)

"New Business" Cost

FREQUENTLY when manufacturing concerns first begin their operations a large amount of expense must be undertaken in introducing their products before the annual profits on the sales amount to enough to bear the expense of this work. Again, even after the business is established, new policies of expansion may be adopted and large amounts of money be expended in advertising, and for samples, salaries, and expenses of special salesmen and representatives, before any adequate returns are secured.

It is quite a common practice among manufacturers to carry such expenses along in some form of asset account until the developed or expanded business reaches a point where the expense of obtaining new business can be paid out of the profits.

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This outlay is sometimes called "Missionary Work" or "Introducing Expense," and an account under some such designation may be found on numerous balance sheets.

The real asset value of such expenditures is difficult to appraise. The utmost conservatism is needed if they are to be considered as assets at all. At most, such expenses amount to deferred charges to the regular expense account, since all money expended in obtaining business, whether new or old, must be charged as an expense of the business sooner or later.

In certain cases the extraordinary amounts over and above ordinary selling expense spent in one year may be considered as the cost of obtaining future business and may be spread over a short subsequent period instead of being charged in total to the expense of the year in which the money is actually disbursed.

Valuation of Good-Will

This discussion leads us directly to the subject of good-will, concerning the value of which opinions differ widely.

An intangible asset, good-will, if admitted to be an asset in any given case, may be of more value than any other item in the entire statement, or, on the other hand, it may be worthless. For this reason it has been suggested that it should not appear as an asset at all.

In a recent case the question of the value of good-will arose. The owner proposed the sum of \$50,000 as the amount which he would accept for the good-will of the business into which he was about to admit a partner. The business had been running steadily behind ever since it was started, five years before. The proprietor, instead of having built up a profitable business, had, in reality, been able to hold his head above water only by means of the capital advanced to him by friendly banks and individuals.

Now in law we say that good-will is the probability that old customers will return to the new proprietors, the assumption being that profits on business brought by these customers will continue without the exertion

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originally necessary to build up an established profitable business.

What good-will can there be in a losing business? Either the customers are inherently unprofitable, or the articles do not possess salable merit to a profitable extent, or perhaps the business, while possessing inherent merit, has been conducted so carelessly that no real profit can exist until the management is changed. If this last condition be found to exist in any given plant, what amount can the proprietor claim for his good-will?

He may have many friends who have that good will toward him which impels them to go to him for goods, but will they continue if the prices are raised to a profitable point or if the management is changed?

It would seem that when a man claims payment for the good-will of his business he should be able to point to the net worth as shown by his books, and also to the profit he has made in the conduct of his business through increasing numbers of satisfied customers. He should be able to say, "Here is

my business. My books do not show all of my assets. I have built up a successful business, which now has a momentum sufficient to insure profits to you right from the start. That, gentlemen, is my good-will."

Good-will, when purchased with the other assets of the business, ought, according to general custom, to be written down each year until it has entirely disappeared from the books. Good-will is an asset of great value when a successful business is being sold, but as a part of a business man's net worth or surplus expressed in the figures on the books it is not so attractive to him or to any one else. When the time arrives for selling the business the buyer will hardly pay any attention to the amount of good-will as expressed in the assets. His judgment will be based upon a thorough examination of the nature and character of the business, its volume, its customers, and its profits, and he will also want to determine from every point of view the effect the staying in or going out of the old proprietors will have on the business.

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Deferred Assets

Under the general heading of "Other Assets" on a balance sheet will appear also prepaid items of expense, such as insurance, taxes, interest, rent, and sundry expenses, which, in a finely calculated system of accounting, constitute items of expense actually paid in the period immediately prior to the inventorying, but a part of which expense, ascertained by calculation, justly belongs to the following period. These items are sometimes classed as "Deferred Assets" or "Deferred Charges to Operation," the meaning of the term being that the items, while not assets in the ordinary sense, are expenses paid in advance and not expenses of the period closed. They form items of expense which have been deferred until the later period of accounting.

Reserve Fund Investments

In the specimen balance sheet of the Scarborough Manufacturing Company are two accounts indicating that the company holds securities of other corporations as invest-

ments. Just what the nature of these investments is does not appear, but the name of one of the accounts, Reserve Fund Investments, is an indication that whatever the securities may be, they have been purchased in pursuance of the idea of actually setting aside and investing a portion at least of the reserved profits.

Among the liabilities will be found Reserves, \$108,417, consolidating several accounts on the books, to which have been credited the periodical instalments of reserve taken out of the regular profit and loss accounts by means of charges.

An analysis of the Reserve accounts is given in the chapter on Reserves, where it will be seen that a part of the amount consists of a Sinking Fund Reserve. Under the terms of the mortgage given as collateral for the loan shown in Bonded Debt, instalments of \$5,000 each year must be set aside so that in twenty years from the date of the loan, when it is due, there will be on hand money to the full amount of the loan ready to pay it off.

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The Scarborough Manufacturing Company set aside the instalments for five years, and invested the amount in first mortgage bonds of several railroad companies. The amount paid for securities, with premium, was, on December 31st, \$22,626.79. The treasurer of the company is awaiting a favorable opportunity to invest the uninvested portion of the reserve.

Other Investments

The "Other Investments" on the balance sheet represents an investment of \$10,000 in some small tenements rented to its employees, on which mortgages had been placed prior to the time the company acquired the property, and also several lots of stocks of corporations which the Scarborough Manufacturing Company has been obliged to take in part satisfaction of accounts due them from customers, and which are carried at \$7,428.72. These stocks have no market value and their actual value could not be determined without a special examination of the affairs of the corporations by which they

are issued. No dividends have been paid on these stocks for a number of years, and the probability is that they are not worth much.

CHAPTER XVII

NOTES PAYABLE

IN THE Scarborough Manufacturing Company statement provision is not made for a separation of promissory notes given for merchandise purchased, from notes given for money borrowed.

In many balance sheets these two different classes of liabilities are shown separately. We will first discuss *Notes Payable for Merchandise Purchased*, which mean unpaid promissory notes or drafts not due, given in the ordinary course of business for merchandise, materials, supplies, or other articles used in the business. The term should include all similar notes payable negotiated by branches, or agents acting for the merchant or manufacturer.

The term Bills Payable is the one most commonly used to designate this class of commercial paper, and as so used it has a more definite meaning to the courts and to

lawyers than the term Notes Payable. It will, however, be found in practical experience that there is frequently considerable confusion in statements of condition between notes given to merchandise creditors and bills received from merchandise creditors, the term Bills Payable being applied to both. Some merchants, manufacturers, and bankers too, think of a Bill Payable as being either a promissory note or an invoice for merchandise. While no lawyer or court would misunderstand the use of the term Notes Payable, many merchants and manufacturers would misunderstand the use of the term Bills Payable, so that it seems best to use the one term which will be best understood by all.

Banks sometimes scrutinize any large volume of notes given for merchandise, under the belief that the better practice for business houses to pursue is to borrow money from bank and pay for their purchases in cash, taking advantage of cash discounts offered. Banks having this view are inclined to think that notes given for merchandise purchased

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indicate inability to properly finance the business.

Notes Payable for Money Borrowed

Notes Payable for Money Borrowed are unpaid promissory notes or drafts not due, given for money borrowed from banks, bankers, or other persons, firms or corporations, for use in the business.

Notes payable to commercial note brokers, or to banks through them, should be stated separately. In some cases the relative proportion between the loans effected through brokers and those obtained directly from banks indicates conditions which would not be clear if the two accounts were consolidated under the general head "Notes Payable for Money Borrowed."

Some large concerns can best finance their operations through the services of note brokers in conjunction with their own banks, while others can be accommodated sufficiently through their own banks without outside assistance.

But some smaller concerns mistake the

position in which note brokers are most useful and go to them to the neglect of their banks. It is usually much wiser for all business men who desire to secure the valuable services of note brokers to do so with the knowledge and acquiescence of their banks.

CHAPTER XVIII

'ACCOUNTS PAYABLE

IN THE general sense, the term Accounts Payable means all unsettled credits to parties for goods purchased, received, and accepted; also credits for unpaid salaries or wages, temporary loans and other unpaid obligations to creditors; amounts owed by a business concern to others as shown by the books, but not represented by promissory notes, drafts, bonds, or judgment of mortgage.

In the more restricted sense, the term Accounts Payable is intended to represent only unpaid invoices for merchandise purchased. It includes only the aggregate of unsettled credits for merchandise, materials, supplies, or other articles purchased for sale, either in its present form or to be manufactured, or for use in the business.

In the ordinary course of bookkeeping, credits of invoices for goods received and

accepted are entered at once in an account with the creditor, regardless of the date of payment called for by the terms of the purchase. Thus any general total of Accounts Payable will not disclose whether the credits are under- or overdue, according to the terms of purchase. In order that a more intelligent understanding of the business may be obtained, it is desirable that the accounts with such creditors be divided into "not due" and "overdue."

Business men want to know what portion of the Accounts Payable is falling due during the next week and month, and they will want to know at the same time what part of their Accounts Receivable may be expected to be collected in time to take care of those payments as they mature.

In the mind of the careful executive it is not enough for him to know that the cash balance is large enough to meet the payments falling due during the next few days. Beyond this, and regardless of the cash balance at any time, he will plan, if possible, to have the collections of debts due his concern pro-

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duce the funds with which to pay all concurrent obligations.

For that reason it is clearer to him if a statement is prepared showing amounts "not due" and "overdue" on both sides of the balance sheet. Of course he will want much more detailed information regarding Accounts Receivable and Accounts Payable than can be incorporated in a condensed statement, but even if they are only classified into "not due" and "overdue," the information is valuable and enables him to make searching inquiries should "overdue" appear in connection with either one of the accounts. Explanations may satisfy him, but he will want to know why the Accounts Receivable are not collected more promptly and why the overdue merchandise bills for purchases by the concern have not been settled and cash discounts obtained.

Care should be taken to ascertain that all invoices for purchases received are entered on the books and included in Accounts Payable. If, according to the method of book-keeping employed by a business establish-

ment, any such invoices are omitted from the books during the year, the amounts thereof should be carefully gathered and stated in the balance sheet. For example, some bookkeepers file bills for such things as office supplies, freight, cartage, and other petty expenses without making any entries concerning them on the books until paid, when the amounts thereof are charged to the expense accounts. At the time a balance sheet is prepared, many such bills may be found on the file, but not among the liabilities on the books. Their amount should, of course, be brought into the balance sheet.

CHAPTER XIX

DEPOSITS

“DEPOSITS” in the sense used here mean credits for money deposited for safe-keeping or in trust for special purposes, such as deposits of employees’ beneficial or savings funds.

Among large manufacturing corporations a custom is growing whereby the management encourages the employees to save a small proportion at least of their wages. Those of the employees who accept the plan consent to the withholding of certain agreed-upon amounts from the pay envelopes, which amounts the company’s officers credit on the general books to some such account as “Deposits of Money by Employees,” or “Employees’ Savings Fund,” as a controlling account, the detailed account with each employee being recorded in separate or subsidiary books.

There are several varieties of these de-

posit arrangements, in some of which interest is allowed by the company, and to which the company contributes regular amounts, either voluntarily each time the contribution is made, or according to a stipulated agreement with the employees, the object being to encourage them to accumulate their savings.

Another phase of "Deposits" is found when deposits are made by customers of a mercantile concern in expectation of purchases at its stores, the amounts of any such purchases being charged to these deposit accounts. Interest is allowed on the average balance of such deposits, and, in addition, an amount is credited to the account of the individual in the form of a certain percentage calculated upon the aggregate of his purchases during the year.

Deposits as used here should not include any loans of a nature calling for entry in other loan liability accounts, nor should it include deferred dividends to stockholders or salaries allowed to remain in the business, or loans from officers, partners, special friends,

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or relatives, intended to be withdrawn on demand.

In order to give a clear conception of the liabilities of the merchant or manufacturer, such loans as may or must be paid prior to the other creditors on open account should be listed separately and fully described.

CHAPTER XX

BONDED DEBT

***B**ONDED DEBT" as used in financial statements means the amount of money borrowed upon a promise to pay at a definite future time, with real or personal property mortgaged as collateral security.*

Usually the mortgage is executed in favor of a trustee for the bondholders, and bonds in convenient denominations are issued, each one of which describes the nature and amount of the debt in general terms, referring to the mortgage agreement for further information, if desired.

Where serial bonds are issued, secured by a mortgage on the plant, the total amount of the bonded indebtedness should be stated "in short," with a deduction of the amount not issued, so that the amount extended in the liability column will represent the net liability.

Ordinarily bonded indebtedness is secured

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by a mortgage covering all of the real estate used in the business. If more than one mortgage or lien exists on the whole or any part of the real estate, it would form a clearer statement of the actual condition of the merchant or manufacturer if these mortgages or liens were separately listed and described and the property on which they form a lien briefly designated.

Where unsold bonds of a corporation are delivered as collateral for loans obtained, a notation of the amount thereof should be made in short under this heading, or in a footnote at the bottom of the statement.

There are various kinds of bonds denoting the lien on the property bonded, such as First Mortgage, Second Mortgage, General Mortgage, Refunding, etc.

There are also Income Bonds, issued by a corporation, the interest on which is payable only out of the income of the corporation.

Bonds may be registered with the income payable to the registered holder, or they may be registered as to principal only with coupons payable to bearer, or they may be pay-

able to bearer both as to principal and interest.

Another term applied to a form of securities is "Debentures," which is an English term meaning bond. While a debenture may be secured by a mortgage, it does not necessarily include the idea of a mortgage. The security may rest in a charge on definite or indefinite property, while a regular bond and mortgage always constitutes a transfer of the real estate covered, the transfer to be defeated only upon payment of the principal and interest.

A form of debenture sometimes arises after a mortgage has been placed on a manufacturing plant and the bonds secured by the mortgage do not sell as readily as expected. Banks may be willing to loan temporary funds on the promissory note or debenture of the company, with the bonds deposited with a trustee as collateral security, when they would not purchase the bonds outright.

CHAPTER XXI

MORTGAGES

WE HAVE just discussed Bonded Indebtedness. In the case of most large industrial corporations the bonds issued for capital obtained consist of serial denominational bonds secured by one mortgage placed upon the corporation's property for the security of all bondholders. In other cases, particularly of the smaller concerns, the regular serial bond does not appear, but instead the loan is obtained by the owners on the concern's single bond with a mortgage on the real estate as collateral, the mortgage being executed in favor of the individual firm or corporation loaning the money. In this class of loans it is usual to describe the form as that of a loan on mortgage, a term which in this sense, as a liability, means

Mortgages or other liens on real estate; money borrowed with the real estate of the business described in the mortgage pledged as security for payment.

In many statements the real estate and machinery forming the plant, if mortgaged, are carried at an amount equalling the difference between the full value and the amount of mortgage. This difference is usually styled the "equity" in the property. But this does not give a just presentation, for besides the lien given on the property, the mortgagor assumes personal responsibility to pay the full amount borrowed in case the debt is not paid when due and the mortgaged property does not produce enough money to satisfy the debt. If the sale of the real estate does not satisfy the amount of the mortgage, the mortgagee can collect his debt out of other assets of the business. For this reason, if for no other, the liability to pay the debt should appear on the books as a liability and the full amount of the real estate and machinery as an asset.

The amount of the mortgages on the balance sheet should also include any mortgage liability, subject to which the property was acquired by the present owner. When property is thus taken over by the merchant or

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manufacturer subject to a mortgage previously placed on it, the purchaser does not under ordinary circumstances assume any personal liability to pay the mortgage.

In such case the rule stated above, that every mortgage should show on the books as a liability, might not seem to apply, but the desire to present a complete statement would still impel one preparing it to set out the full mortgage liability of the concern.

In making up an ordinary statement the question of priority of liens does not arise. It is only necessary to show the full amount of the real estate as an asset and the amount of liability in the form of liens against it. It would be very difficult to prepare the ordinary balance sheet of a merchant or a manufacturer so that it would exactly express the relation between the various classes of his secured and unsecured creditors so that his full and complete legal relation to each and all would be indicated.

If real estate other than that used in the immediate operation of his business is owned by the merchant or manufacturer, the

amount of such real estate should be stated as an asset separately from the amounts of real estate used in the business. Likewise, where mortgages or other liens exist against this separate property, such mortgages or liens should be stated in the liabilities separately from the mortgages or liens on the real estate used in the business.

For example, there might appear

In the Assets—

Land and Building in Plant...	\$200,000
Property, 15th Street.....	10,000

And in the Liabilities—

Mortgage on Plant.....	50,000
Mortgage on 15th St. Property	2,000

In order to carry out the idea of fully expressing assets and liabilities on the balance sheet, it is desirable that the full value of land owned subject to an annual ground rent be carried as an asset and the capitalized lien of the ground rent be entered as a liability.

In short, the balance sheet should include the amount of all instruments recorded or unrecorded, which are or which may become when recorded a lien on the real estate.

CHAPTER XXII

OTHER LIABILITIES

IN THE usual balance sheet form provided by banks for the use of customers there rarely appear separately listed liabilities other than those which have been described. In ordinary cases all liabilities of the merchant or manufacturer are shown in these accounts, except such small incidental expenses as are commonly omitted from even carefully calculated statements of condition. Sometimes, however—and frequently in some lines of business—items not found in the accounts described in the foregoing chapters must be entered in the balance sheet. To provide for such items the term “Other Liabilities” is frequently printed at the bottom of the statement, with a blank space or two for separate classes of items.

Sometimes under this heading appear accounts showing the amount of dividends declared but not yet paid, unpaid legal fees,

insurance, rent, taxes, interest on ordinary loans and on bonded debt, royalties, and commissions, which items may or may not show under the heading of Accounts Payable, according to the method of bookkeeping employed.

In many cases when an analysis is made of the lumped accounts described as "Other Liabilities," items are found which materially alter the impression produced by an inspection of the statement before such analysis is made.

Accrued Liabilities

In addition to the unpaid items due at the time of the preparation of a statement, and any items which though not due have been passed through the books into Accounts Payable, there may be other items for salaries and wages, insurance, rent, taxes, or interest, which, though constituting liabilities to the amount accrued to the time the statement is made, may not be actually due for payment until some time later. In order that the full liability of the concern may be shown, a care-

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ful calculation should be made of the proportion or part of the liability accrued on each of these items to the date of the statement.

For example: If the pay-roll week ends on Thursday, the 28th of the month, and the fiscal year ends on the 30th of that month, there will be the wages of the plant for two days to take into consideration, although the next pay day will not arrive for four working days after the end of the fiscal year. The product on which the men were engaged is taken as an asset, so the unpaid wages for the two days should be stated as a liability. Thus, assuming the total weekly wage roll to be \$60,000, the accrued wages will be \$20,000.

In the ordinary business concern, if the bookkeeping is well managed, the amount of accrued items should not be large enough to materially affect the net worth in most cases, the accrued assets omitted from the statement practically offsetting the omitted accrued liabilities.

But in many cases the addition of these

accrued items will throw quite a different light on the business, especially where such items are large and are paid at infrequent intervals. If, for example, the taxes of all kinds amount to a considerable sum, and are paid but once each year at about the same time, the amount of accrued taxes just prior to the payment would be a material item. But under a good system of bookkeeping the amount of these taxes is spread over the expenses of the year in monthly instalments, which appear on the books as a liability before the actual payment, or, if taxes are paid in advance, their amount is distributed in the same manner, so that the actual cash payment, while depleting the cash balance to that extent, does not disturb the net worth of the concern.

CHAPTER XXIII

CAPITAL AND CAPITAL STOCK

THE excess of assets over liabilities constitutes the net worth or capital of an individual, firm, or corporation for whose statement of financial condition the balance sheet is prepared. In the economic sense of the word, capital means wealth, and in that sense all of the assets to which the possessor has legal title constitute his wealth or capital, regardless of his unpaid debts, even though these may have been incurred in the purchase of some or all of those assets.

In the business sense, however, capital means the amount of one's own capital or interest in the business as distinguished from capital borrowed from others, either directly as a loan or indirectly by means of purchases of equipment, material, or supplies for which payment has not been made. Thus, in order to find the net capital of any concern, the liabilities must be deducted from the assets,

the remainder constituting the capital or net worth of the business.

When the net profits of an individual sole owner of a business are ascertained, the amount is usually transferred directly to his capital account, which should at the end of every closing period form the exact balance between his assets and his liabilities, and exhibit his net worth.

In the case of a partnership, the net profits are usually divided at the end of stated periods according to the terms of the partnership agreement, and the amounts so determined are credited to the several partners' accounts, the sum of these accounts forming the capital or net worth; provided, both as to individuals and partnerships, that care has been taken in adjusting the book value of the assets to agree with the actual value as nearly as possible; and provided also that all of the assets and liabilities are placed upon the books.

In an individual's or firm's statement the capital will be shown by the credit balance of the individual's or partners' capital accounts,

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a capital account being kept in the name of the individual owner, or, in case of a firm, in the name of each and all of the partners.

Capital Stock

In a corporation, if only one kind of stock is issued, the capital will be shown in the sum of the Capital Stock account on the ledger, or, if more than one kind of stock is issued, then in accounts for all classes of issues. The capital stock should be entered at the par value of the shares issued, unless these are issued when only part of their par value is paid, in which case the amount paid in only should be credited to the capital account. The holdings of each individual are shown in a subsidiary book called the "Shareholders' Ledger," the aggregate of the shares credited to the individuals agreeing at par with the amount of capital stock issued, as shown in the one account of each class of stock on the general ledger.

The capital stock of a corporation may be divided into several classes, such as common, first preferred, second preferred, etc.

There are other kinds of stock that may be

issued, but these are the most frequent. In fact, it is not usual for manufacturing or trading corporations to issue other than "common stock" and "preferred stock."

Until comparatively recent years the entire capital stock of a corporation consisted of what is now known as "common stock," and it was issued for cash or for property acquired for use in the business. Originally the use of preferred stock was generally limited to cases in which the common stock had all been issued and additional capital was needed. The special stock was then issued to those who would furnish the capital.

The use of this stock is not now limited to special purposes. Such stock is known as "preferred" stock because the individuals to whom it is issued possess special privileges or "preferences" not possessed by the common or ordinary shareholders.

In some cases the special privileges of preferred stock consist in the right to dividends at a stipulated rate before the common shareholders can receive any of the profits of the business.

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An additional privilege is given to some of the issues of preferred stock described as "cumulative preferred," consisting in the right to receive "back" or unpaid dividends before the common shareholders can receive dividends in case the corporation fails in any one or more years to earn profits to a sufficient extent to pay the current stipulated dividend on the preferred stock.

In other cases the preferred stockholders are not only preferred as to dividends, but in addition they are preferred as to distribution of assets upon dissolution of the corporation after liabilities are paid. Some of the preferred stock issues possess one or more of these special privileges and some possess all; the special preferences over ordinary shareholders being granted to make the preferred stock more attractive to purchasers.

Formerly when preferred stock was issued, it was intended, as a rule, to call it in and pay the shareholders its par value within a short time, the common shareholders being left in possession of their full rights to profits and property. This idea is still retained in some

issues of preferred stock, but it is not so common as formerly.

In later years a great many corporations have been formed to take over existing properties and have issued preferred stock or bonds for the cash and property acquired, while the common stock has either been given along with the preferred stocks or bonds as a bonus, or has been issued for the supposed good-will of the acquired properties. As a result, the common stock has degenerated into a condition in which in many corporations it represents very little, if anything at all, when first issued.

Capital Stock and the Property Account

In inspecting the balance sheet of a corporation it is very important to determine whether all of the stock has been issued for actual property or whether some of the amount outstanding represents nothing of any tangible value. Frequently we find in balance sheets a condition similar to the following:

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no other assets large enough to explain their issuance.

The capital stock issued amounts to \$5,000,000, while the Property account amounts to \$4,552,339, showing that the balance of the stock, amounting to \$447,661, was probably issued for other assets. It may be, of course, that the entire issues of both classes of stock were given in payment of the property, which was then valued at \$5,000,000. In this case, since the Property account balance is less than the par value of the stock, the company has presumably applied its earnings to the reduction of the Property account.

Enough has been suggested as to the possibilities in this case to show that the use of the bulk account "Property Account" prevents the observer from accurately ascertaining the true condition of a corporation in whose balance sheet the item is found.

CHAPTER XXIV

SURPLUS—PROFITS

IN THE restricted sense, surplus means accumulated undivided profits arising from the operation of a business.

When used in a less restricted sense, particularly in a corporation statement, it means the excess of assets over liabilities and capital. In this sense surplus may include, besides the profits of the business, gains arising from acquisition of assets other than those that form the purpose for which the corporation was organized.

An example of surplus under the less restricted use of the term is furnished when stock in a corporation is sold to subscribers at a fixed amount per share over and above the par value, the excess providing a surplus at the beginning of existence of the corporation. This method of establishing a surplus is not often used by other than financial or insurance institutions.

Surplus Not from Earnings

An example, sometimes found in ordinary manufacturing corporations, of an increase of surplus not due to earnings is furnished when subscribers donate to the corporation for its own benefit shares of capital stock previously purchased by them. When treasury stock thus acquired without cost to the company is placed on the books in money value, some bookkeepers credit a corresponding amount to the Surplus account. To the ordinary observer this gives the false impression that the Surplus account shown on the balance sheet has been earned by the company from the operation of the business.

Some accountants place the amount so obtained to the credit of an account called "Working Capital" or "Capital Surplus," in order to distinguish the book surplus so acquired from the earned surplus.

Another case of increased surplus not due to earnings is sometimes found when a business owned by an individual or partnership is sold to a corporation, the payment being made in capital stock of the company. If the

amount of stock issued at par is less than the book value of the net assets taken over and the amounts of the assets are transferred to the books of the corporation without deductions, a surplus of book assets over liabilities will be created which the bookkeeper will probably credit to Surplus account.

If the net assets are worth the amount at which they were entered on the new books, of course the surplus so constituted is a real surplus, although not earned by the new company; and nothing further need be said, save that, when subsequent balance sheets of the new corporation are prepared, a clearer statement of condition is presented if the surplus acquired from the old business is shown separately from the surplus or accumulated profits earned by the new corporation.

But in some cases the assets of the old concern are not worth their book value, and the apparent surplus is no real surplus at all. In such cases the Surplus account may be misleading to any one inspecting statements of the corporation, because the natural presumption is that the Surplus account repre-

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sents profits earned, and indicates the ability of the company to build up not only a successful dividend-paying business, but as well to provide a reserve against future needs. Inquiry should always be made concerning the Surplus account in order that it may be made clear just what part of it has been earned and what part has been built up by other means.

Accounts in Which Surplus May Appear

If the excess of assets of a corporation over liabilities equals the capital, there is no surplus, in the general sense, the capital just balancing the excess or net worth of the business, but if there is an excess of assets over liabilities and capital, there is a surplus, and while it may not be shown under that name, it is there. It may appear in a business statement as Profit and Loss, Earnings, or Undivided Profits, or be shown in part by a surplus account representing accumulated profits earned prior to the current year and in part by a profit and loss account representing only the balance of profits of

the current year after all expenses are paid and dividends disbursed.

When any classification of the surplus is shown in the statement, a good arrangement is as follows:

(a) Surplus—representing accumulated undivided profit to the beginning of the current fiscal year.

(b) Profit and Loss—representing the net profits for the current fiscal year.

(c) Special Surplus—book surplus derived from sources other than actual earnings.

The surplus account is not commonly found on the books of individuals and firms, the profits being accumulated in the owners' capital accounts in the manner already described.

In one sense, the surplus of a business means the excess of assets over liabilities, and it is sometimes called "Surplus Assets." In the case of individuals and firms, surplus means the same thing as capital or net worth.

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The Corporate Surplus

In corporation accounting more formality is required than in that of firms or individual owners, and the usual procedure when a balance sheet is taken calls for the finding of the net profits for the year and then for the determination of how those profits shall be appropriated, including the amount to be distributed in the form of dividends to the shareholders. After the deductions for extraordinary expenses, investments, etc., are all made, the net amount is usually transferred to the Surplus account, where it remains as a fund which may be drawn upon to meet extraordinary occurrences or for payment of dividends in years when the net profits are not sufficient in themselves to pay the customary or desired dividends to stockholders.

As will be seen, the term "Surplus," when used in corporation accounting, does not merely indicate the excess of assets over liabilities, but is used to show the excess of assets over both liabilities and the contributed capital as represented by the shares of

stock issued. This is shown in the following illustration:

Assets	\$500,000
Liabilities	250,000

Net Worth.....\$250,000

Capital Stock..... 200,000

Surplus \$50,000

or put in the ordinary balance sheet form:

Total Assets..\$500,000	Total Liabilities\$250,000
	Surplus 50,000
	Capital Stock... 200,000
<u>\$500,000</u>	<u>\$500,000</u>

This use of the term surplus does not at all affect the idea of net worth, which means, in each and every case, the excess of the actual value of the assets over the total of all the liabilities at the time the calculation is made, regardless of the capital contributed originally or the amount of the capital stock issued and outstanding.

Thus in the foregoing example the net worth is \$250,000, divided into

Capital Stock.....	\$200,000
Surplus	50,000

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Corporate Liability for Surplus

The corporation, as a separate entity from the shareholders as individual contributors, is certainly answerable to the shareholders not only for the money contributed, but as well for the amount of surplus or accumulated profits not previously distributed to them in the form of dividends.

This liability of the corporation to its shareholders is, however, of a different nature from that of its liability to its outside creditors, for while it must ultimately account to the shareholders for the amounts of their contributions and profits, its accounts with creditors must first be settled. If the corporation is liquidated, and after settlement with all creditors a balance of assets is found to be in hand, the shareholders are entitled to a distribution of those assets pro rata according to the number of shares held by each, taking into account, of course, the prior rights of the preferred shareholders, if any. If the balance of assets so distributed equals or more than equals the amount of the shareholders' contributions, well and

good; but if the settlement with creditors leaves a balance of assets too small to repay the shareholders, they must suffer whatever loss they sustain without complaining, unless, indeed, some action may be taken by the shareholders against the officers and directors for the mismanagement that has produced the unfortunate or criminal condition.

But, except in cases where the mismanagement is such that the law will compel those in charge of the affairs of the corporation to reimburse the shareholders, they have no redress for their losses. Hence the statement that the liability of a corporation to account to the shareholders is not a liability in the usual meaning of the term.

Corporate Deficit

Sometimes we find in balance sheets this condition:

Assets	\$450,000	Liabilities	\$300,000
Deficit	50,000	Capital	200,000
<hr/>		<hr/>	
Total	<u>\$500,000</u>	Total	<u>\$500,000</u>

which means that while the net worth of the

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concern is \$150,000, its capital has been impaired to the extent of \$50,000. The surplus not only does not exist, but in its stead there is a deficit, or shrinkage in the actual book value of the capital stock.

Stated in another way, the condition would be:

Assets	\$450,000
Liabilities	300,000
	<hr/>
Net Worth.....	\$150,000
	<hr/>
Capital Stock.....	\$200,000
Less Impairment.....	50,000
	<hr/>
	\$150,000
	<hr/>

In whatever form the surplus appears on a balance sheet, inquiry should be made as to its source, and an analysis of this account for a period of not less than five years immediately preceding the date of the balance sheet will throw much light upon the condition of the concern whose net forward or backward movement it represents.

CHAPTER XXV

RESERVES

RESERVE accounts consist of charges against the earnings of the business transferred to these accounts as credits, for the purpose of offsetting shrinkages in asset values. The most common of these reserve accounts are ordinarily designated as "Reserve for Bad and Doubtful Debts," and "Reserve for Depreciation of Plant." In some cases an account representing the same thing appears as "Contingencies Account" or "Reserve for Contingencies."

In the ordinary form of balance sheet the total of the debit balances, or assets, is shown at the foot of one column and the total of the credit balances—including capital, surplus, and reserves—is shown at the foot of the other column. Of course such items as reserves are not liabilities, but they are placed in the liability column to offset the book values of the assets. In other words,

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when the assets are listed in the statement at the full cost value, reserve accounts should be shown under the head of liabilities.

Reserve for Bad and Doubtful Debts

Reference has been made to the care which must be exercised in valuing open accounts due from customers. After all accounts known to be worthless are eliminated and the remainder seem perfectly good, there is still some probability that the actual cash to be realized in the collection of the accounts will fall short of the full face value thereof. It is rarely that accounts representing several thousands of customers and aggregating hundreds of thousands of dollars will each and every one be settled without loss or expense for collection.

For this reason an amount calculated as a certain percentage of the total of sales, based upon past experience, should be set aside out of the profit as a reserve to provide against shrinkages of this kind which would otherwise render the statement of the concern's net worth misleading.

The amount so set aside becomes an estimated loss for bad and doubtful debts, though these debts are not known to be bad or doubtful at the time the statement is made. The amount set aside is placed to the credit of the reserve account. Sometimes the corresponding debit is charged direct to Profit and Loss account, but more often, and particularly in bookkeeping systems where it is desired to show the full operating expenses, the amount is charged to some one of the operating expense accounts, the credit of course being, as before, to "Reserve for Bad and Doubtful Debts."

During the year, if the amounts of all customers' balances actually found to be worthless are charged off—i.e., credited to the customers' accounts and entered as debits to the Reserve for Bad and Doubtful Debts—and all the other accounts open at the beginning of the year have been collected, the balance of the reserve account will show how closely the real shrinkage has been approximated. If the account shows a credit balance remaining over and above the total amount

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charged against it, the excess of credit will indicate the amount by which the bad debts were overestimated. If, on the other hand, the charges or debits for bad debts exceed the amount credited as a reserve, this indicates that the amount of the bad debts was greater than anticipated, and a larger amount should be reserved for the next year.

Reserve for Depreciation of Plant

Sometimes, on books of large manufacturing corporations, there are several accounts showing reserved profits set aside to guard against overvaluation of assets, but more often one general account is used to include all depreciation credits for the buildings, machinery, and miscellaneous articles of equipment constituting the plant.

In some cases the amount of depreciation is roughly estimated, while in other cases the amount is carefully calculated after considerable investigation and consultation with the superintendent and foremen of the various departments, or with outside experts.

In some systems of bookkeeping, besides

the general ledger showing the plant assets in two or three general accounts, a separate plant ledger is regularly kept, in which detailed accounts for every important building and machine are entered, showing the original cost, the repairs expended thereon since the asset was acquired and also during the year, and the estimated annual depreciation. The total sum of the annual depreciation against each item forms the aggregate amount of the depreciation charge for the year as shown on the general books.

Any calculation of net worth must take into consideration the amount of depreciation and the expenses of keeping the plant in good condition.

Many manufacturers think that a certain definitely stated percentage of depreciation used by one manufacturer may be safely used by all manufacturers, regardless of the character, location, and condition of the manufacturing plant, and also regardless of the varied personal skill exercised in the operation of the machinery.

For example, a pamphlet prepared by a

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“committee of accounts” was sent to all the manufacturers belonging to a certain association, and in this pamphlet it was stated to be well settled that buildings depreciate 5 per cent. and machinery 10 per cent. per annum. There is no such settled fact or principle. Buildings and machinery of exactly the same materials and make will not depreciate at the same rate in Colorado as upon the Atlantic coast. Nor will two managers in the same kind of business direct the operation of the machinery of their different plants in the same way and with the same percentage of depreciation, even though the volume of business is exactly the same.

If two plants exactly alike at the start do not depreciate in the same proportion, how can any arbitrary figure be applied to buildings and machinery generally? Each plant must be carefully studied and depreciation reserves fixed with regard to the circumstances affecting the plant.

CHAPTER XXVI

RESERVES (*continued*)

SOMETIMES in balance sheets the reserve for bad debts or for depreciation is stated as a "Reserve Fund," and the question is raised as to the meaning of the word "Fund" used in that connection. In the ordinary use of the term, "Fund" indicates an asset such as cash or its equivalent. Those who regard this as the proper and only meaning of the word wonder why it appears on the liability side of a balance sheet. Those who use the term to designate a reserve of profits explain that a reserve is, in effect, a setting aside of profits of a business to obtain funds for replacement of worn-out buildings and machinery and that the reserve account shows the amount of such fund. In other words, it is an account of the profits reserved to provide a fund—a Reserve Fund account.

With some concerns it is the practice not

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only to set the profits aside, but to go one step further and invest cash in securities of other corporations to the amount of the reserve. Thus the invested cash becomes the real reserve fund, and the amount which may be invested is shown by the Reserve Fund account. Since the word "account" on a balance sheet is unnecessary, as all of the items found there constitute balances of *accounts* on the ledger, or of accounts which would be there if the method of bookkeeping were complete, the word "account" is dropped, leaving "Reserve Fund," a somewhat cloudy term when used as a liability. But the term does not present any difficulty to one familiar with the examination of balance sheets, although the title "Reserve for Depreciation" or "Reserve for Replacements" is clearer.

Another important account appearing on some balance sheets as a liability consists of the "Sinking Fund," which appears when, under the terms of a mortgage, certain definite amounts must be set aside periodically for the purpose of extinguishing the mortgage

liability when it matures. In some of these cases the fund must be created out of profits earned, while in other cases it is immaterial how it is created, the only requirement being that instalments be actually set aside and invested each year.

If, under the terms of the mortgage, or according to the adopted policy of the company, the actual money must be set aside and invested, the asset side of the balance sheet should show the account of the investment of such funds. If the mortgage contract does not provide for the actual investment of the fund, it may be left in the business as part of the assets of the business, the account thereof being kept as a liability, or Sinking Fund Reserve, increased by periodical transfers from the Profit and Loss or Surplus account.

The form of statement shown in Chapter I provides for a grouping of the "Reserves" in one amount, which, in the case of the Scarborough Manufacturing Company, consists of the following:

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Sinking Fund	\$25,000
Bad and Doubtful Debts.....	3,017
Depreciation on Buildings.....	32,000
Depreciation of Machinery and Fixtures..	48,400
<hr/>	
Total	\$108,417

The Sinking Fund Reserve consists of five credits of \$5,000 each. The Reserve for Bad and Doubtful Debts amounts to about 3 per cent. on the total of the outstanding accounts, which in this case, based on past experience with the company's customers, is a sufficient provision.

The Depreciation on Buildings consists of an accumulation of lump sum charges extending over a period of ten years, and while not based upon any special plan, seems to be more than sufficient for depreciation. The same comment may be made on the Reserve for Depreciation of Machinery and Fixtures. In fact, this company has accumulated reserve credits to a larger amount than is ordinarily found in manufacturing plants of its size.

Hidden Reserves

Some merchants and manufacturers in preparing balance sheets are so conservative in their valuations of assets that the balance sheets do not represent the full net worth of the business. While it is commendable for the proprietor of a business to understate rather than overstate his net worth, except, of course, under conditions wherein the understatement would be of advantage to him—as, for example, in preparing tax reports or returns—it is a much better practice for a manufacturer or merchant to calculate his net worth as accurately as may be without either over- or understating.

Since the accumulated profits of a concern, set aside in reserve accounts for the purpose of guarding against embarrassment from unexpected shrinkages of the assets, constitute reserves built up to protect those assets, the excess of the actual value of assets over the amount shown on the books is considered in the nature of another reserve. For want of a better name the term "Hidden Reserve" or "Secret Reserve" is used to indicate that

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a concern possesses secret or hidden reserves not disclosed on its balance sheet, these secret or hidden reserves consisting of resources not claimed in the process of striking a balance and producing the amount of net worth.

The practice is one of doubtful propriety. Of course, an individual sole owner of a business who is under no obligation to state the full value of his business may follow his own inclinations in this matter without question. An example of the extent to which it may be carried is given in the case of a wealthy manufacturer, among whose assets is listed a large wharf or pier, on which are erected numerous buildings for shipping purposes and from which a large income is derived. While this pier is easily worth \$750,000, the owner carries its value on his balance sheet at \$1 only, its real value having been reduced from time to time out of the earnings derived therefrom. This manufacturer's actual net worth, as compared with the statement of his balance sheet, would thus contain a secret or hidden reserve of almost the entire value of this pier, taking, of course, into account

reasonable provision for ultimate replacement.

In the case of a small firm the condition might be such that the inclination of the members to build up secret reserves could be safely followed, but even in such cases less difficulty would arise upon dissolution of the firm by death or otherwise if the assets were shown within a reasonable degree of value accuracy.

But when we come to the accounting of a corporation, particularly one whose shares are more or less widely held, the propriety of materially understating the assets may be questioned, because the rights of shareholders, past, present, and future, may be seriously affected by their lack of knowledge of the actual conditions.

Methods of Building Up Secret Reserves

One of the most common methods of creating the so-called hidden or secret reserve consists in an excessive charge to profit and loss for depreciation of plant assets; the amounts being charged direct to the Profit

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and Loss account, and the credits being made direct to the plant asset account, the effect being to reduce the book value of the plant asset account below its real value.

Another method of hidden reserve building consists in the charging of enlargements of a plant to current operating expenses. One large concern whose published statement has been issued for years has made from time to time extensive additions to its plant, and without any effort whatever to conceal the practice, charged the cost of these additions to operating expenses. The result is that the property accounts as shown on the books are to-day carried at a value far below their real worth.

In this case, while there is no attempt at deception, the practice being known to all concerned, there is no way by which the total amount of such improvements and additions can be readily obtained, and for this reason the plan is not to be recommended.

In another case an entire new plant was erected without any increase in the book value of the plant accounts of the company,

the instalments due to the contractor as the building progressed being paid out of the current earnings of the company, so that to-day this large building, worth over a million dollars, does not appear on the books of the company at all.

CHAPTER XXVII

CONTINGENT LIABILITIES

CONTINGENT LIABILITIES are those amounts not directly owed by the merchant or manufacturer, but which may become direct liabilities upon the happening of certain contingencies.

Since the balance sheet is intended to include only direct liabilities, such contingent liabilities should not be included in the regular statement of financial condition, but should be stated as footnotes.

Notes Discounted

An example of a contingent liability is found in Notes Receivable which have been received from customers, endorsed by the merchant or manufacturer and discounted at bank. Having been received from customers for goods sold, the makers are expected, of course, to pay them at maturity. Should, however, the maker of any such note fail

to meet his obligation, the merchant or manufacturer receiving and discounting the note may become primarily responsible and be obliged to pay. If he keeps a proper notes receivable record, he will at all times be able to ascertain the amount of the Notes Receivable not yet due on which he may become liable in the event that the maker does not pay. The Notes Receivable Book referred to is a useful record, showing details of notes received, such as date, amount, maker, indorsers, maturity, etc. It is sometimes incorporated in the bookkeeping system, but is more frequently used only as a memorandum book.

It will be remembered that under the discussion of Notes Receivable it was said that some concerns show the contingent liability for Notes Discounted in the body of the balance sheet. This is done by crediting on their books in a Bills Receivable Discounted account all of the notes discounted, against which they charge all notes as they are paid by the makers, so that the balance of this account shows the amount of unpaid notes

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which have been discounted but which have not yet been paid.

Where such a system is in use, of course, no footnote showing the contingent liability for notes discounted is required.

Accommodation Paper

Another form of contingent liability consists of that arising from accommodation indorsements.

Any accommodation paper made by the merchant or manufacturer or indorsed by him for the benefit of other parties, the proceeds of which are not received by him and entered on his books, should be stated as a Contingent Liability.

Any liability for exchanged notes, drafts, or checks, and any liability for guaranty or suretyship should also be stated.

Ordinary business concerns are usually very chary about lending the use of their names on promissory notes for the accommodation of the makers. In fact, in some corporations this favor is prohibited under the charter and by-laws, and in some partner-

ship agreements no one member of the firm is allowed to indorse promissory notes, either in his own name or the name of the firm, for any outside parties or for any outside purpose. So many business failures have been brought about through friendly but unwise indorsement of promissory notes that such provisions must be regarded as measures of mere ordinary business procedure.

Unfortunately, concerns whose credit and capital are limited do sometimes exchange such accommodations with each other. In one case, a small manufacturing corporation, through the aid of certain loose-principled note brokers, managed to exchange notes with thirteen other manufacturing concerns in similarly crippled financial condition. Of course the inevitable collapse took place after a short period of easy financing, and the one concern having least need for such irregular methods had to bear the brunt of the total failure of all of the other concerns on whose paper it had indorsed its name. Besides its own direct liability on promissory notes given to the others for their accommodation, this

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concern had, in addition, its contingent liabilities for its indorsements on the notes of all of the others—a condition which eventually brought it into the bankruptcy court.

Liabilities Not Shown by Books

In examining his own balance sheet or that of others the business man or investor should satisfy himself by inquiry that there are no liabilities, contingent or direct, other than are shown on the statement.

Merchants or manufacturers may and frequently do enter into contracts for purchase or sale of goods, and sometimes participate in syndicates or subscribe for corporation securities, thereby incurring liabilities which by their nature may not be entered on the books in any ordinary bookkeeping. These may, however, have a material effect on the financial condition of the individual or concern at the time the balance sheet is made, according to the favorable or unfavorable happening or turn of events. At the time the balance sheet is prepared, any knowledge of events which may forecast loss or disaster

should be faced squarely by the merchant or manufacturer if he wishes to avoid self-deception, even though such knowledge comes to him before the time for the performance of the disastrous contract or engagement.

CHAPTER XXVIII

ANALYSIS OF BALANCE SHEET

- H**AVING considered the nature of the accounts forming the balance sheet shown in Chapter II, let us see whether we can derive any information from the grouped accounts of this same balance sheet, expressing as they do the net worth of the business.
- The balance sheet of the Scarborough Manufacturing Company presents a typical case of a corporation statement reshaped to conform to the requirements of the American Bankers' Association.

One of the first things to consider in the analysis of a balance sheet is the "liquid" condition of the assets as compared with its immediate liabilities. The statement of the Scarborough Manufacturing Company presents a very favorable condition from a banker's point of view. Cash, Bills Receivable, Accounts Receivable, and Merchandise, representing what are usually called "quick"

or "liquid" assets, amount to about \$370,000, while the "quick" liabilities—Notes Payable, Accounts Payable, and Deposits—amount to but \$88,000 in round numbers. This condition presents a desirable one, in that the "quick" assets exceed the "quick" liabilities in the ratio of about $4\frac{1}{4}$ of assets to 1 of liabilities.

Of course the nature of the business is taken into consideration, but banks as a rule do not look with favor upon a statement unless it shows at least \$2 of "quick" assets for every \$1 of "quick" liabilities.

Readings from the Balance Sheet

That the Scarborough Manufacturing Company is somewhat easy-going is evidenced by the large cash balance as compared with the amount of accounts payable outstanding. It is probable that active efforts directed toward reducing that liability might result in material savings in the way of cash discounts.

Again, the credit terms of this concern to its customers average 45 days, but through

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easy collection methods it has allowed about \$25,000 of overdue outstanding accounts to remain uncollected.

Another evidence of slack methods is shown in the large amount of merchandise on hand, which equals about one-third of the total volume of sales for the year, while, as we have seen, the natural "turn-over," according to the accounts receivable, occurs about nine times each year. In other words, with a volume of sales of \$680,000, and with a credit period averaging 45 days, the amount of stock on hand in excess of \$80,000 could only be justified by a process of manufacture requiring an unusually long period as compared with the credit terms upon which this stock is sold—a condition which does not exist in the case under consideration.

Another evidence of an easy-going management, not pressed by necessity or keen watchfulness, is shown in the mortgage of \$5,000 on certain property owned by the company, on which it is paying 6 per cent. interest. Its bank balance is producing no interest whatever. Keen financial men abhor

conditions under which they unnecessarily pay more interest than is earned.

It is very evident from the statement that the company has enjoyed rather more than average prosperity since it has been able to accumulate a large surplus, besides setting aside ample reserve provisions, in spite of its easy-going propensities.

Those in charge probably know very much about what is called the practical end of the business, and in that are evidently sufficiently successful to be able to ignore phases of the business which in other concerns receive the utmost care. Of course, the net result would be better if the loose ends could be gathered in without sacrifice elsewhere.

CHAPTER XXIX

COMPARISON OF SUCCESSIVE BALANCE SHEETS

IF a single balance sheet will convey solid information regarding the concern whose condition it represents, how much more is gained by a comparison of the balance sheets of the same concern for two or more consecutive years?

Let us take the balance sheets of a large public service corporation for the years 1910 and 1911 and set the figures side by side for comparison.

THE INTERNATIONAL SERVICE COMPANY

Assets	1910	1911
Cost of Property.....	\$557,417,146	\$610,999,964
Contracts in Process..	7,212,781	2,943,381
Inventories	17,048,196	20,987,551
Accounts Receivable..	49,744,919	26,077,802
Cash	32,055,866	27,548,933
Investments	38,166,284	64,766,089
Total.....	\$701,645,192	\$753,323,720

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Liabilities	1910	1911
Capital Stock.....	\$352,904,063	\$344,645,430
Surplus and Reserves.	95,700,385	119,598,526
Bonded Debt.....	187,685,339	224,791,696
Bills Payable.....	40,721,625	42,566,943
Accounts Payable.....	24,633,780	21,721,125
	<hr/>	<hr/>
Total.....	\$701,645,192	\$753,323,720
	<hr/> <hr/>	<hr/> <hr/>

Cost of Property Account

It will be observed that in the foregoing form of balance sheet the accounts are arranged somewhat differently from those of the two other balance sheets which have already been shown.

The property account of one of the prior examples appears here in a more definitely named "Cost of Property" account. While an analysis of the account might perhaps show the assets to be worth less than the amount at which they are carried on the books, the balance sheet is evidently intended to convey the impression that whatever the value of the property, its cost is here stated.

Now we naturally turn to the record of depreciation to learn the amount charged off

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as a provision against the shrinkage of property values, but here we are met with an obscurity. The surplus and the reserve accounts, instead of being stated separately, are thrown together in one lumped account, so that we cannot tell just how much the company has thought necessary to set aside as a reserve against the depreciation of its costly plant.

We may observe, however, that the cost of the property exceeds the entire amount of capital stock issued. In fact, it exceeds that amount in addition to the entire bonded debt. This is as far as we can go in this direction without asking the management questions.

Results of Operation

Now let us see the result of the operations of this company as disclosed in these two statements. We notice that no two of the amounts, either of the assets or liabilities, remain the same for both years. What funds did this company handle during the year and what did it do with them?

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Take the assets first. Which of them were decreased? We ask this question because we know that if an asset was decreased during the year, it is probable in the natural course of events that the amount of the decrease represents cash realized. Assets may be, of course, written down or taken off from the books altogether without producing anything but loss, but where reserve accounts are kept and property is carried at cost, it is not probable that the asset values were reduced excepting for cash realized.

The Accounts Receivable,

On December 31, 1910, amounted to..\$49,744,919

While on December 31, 1911, the

amount was 26,077,802

A decrease of.....\$23,667,117

which means that an amount equal to the entire current accounts for the year was collected, and additional collections were made to the extent of \$23,667,117, thus increasing the company's working capital by this amount.

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On the other hand—

Cost of Property in 1911 was.....	\$610,999,964
While in 1910 the amount was.....	557,417,146

An increase of..... \$53,582,818

which shows that an increase of property took place during the year, consuming funds to the extent of \$53,582,818. That this did not all come from capital, either in the form of share capital or increase in bonded indebtedness, is clear when we observe that the outstanding capital stock actually decreased. While the bonded debt increased \$37,106,357, the amount is still about \$16,000,000 less than the additions to plant.

Comparison of Asset and Liability Variations

Where did the company obtain the funds to purchase this additional property? We know that the increase of liabilities, represented by accounts or notes payable, or by bonded debt or share capital, should produce a corresponding increase of assets in some form, and that the reduction of such liabilities calls for the parting with assets.

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Combining the decrease of assets and the increase of liabilities, we get the following results:

DECREASES OF ASSETS AND INCREASES OF LIABILITIES:

Contracts....	(decrease)	\$4,269,400
Accounts Receivable.....	(decrease)	23,667,117
Cash	(decrease)	4,506,933
Bonded Debt.....	(increase)	37,106,357
Bills Payable.....	(increase)	1,845,318
Surplus and Reserves.....	(increase)	<u>23,898,141</u>
Total		<u><u>\$95,293,266</u></u>

This represents the total amount which during the year became available for expenditure on any one of the items in the balance sheet. Of course this calculation does not furnish us with the gross earnings or the operating expenses. We do not have the profit and loss statement before us. That has all been boiled down to the remaining "Surplus and Reserves," the increase of which is all we have to serve as a guide. Further along the line of detailed operation we cannot go, but we do know that after cur-

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rent operating revenues and expenditures have been accounted for, there is a decrease of assets and an increase of liabilities aggregating \$95,000,000, which was spent somewhere. Where did the money go?

Our answer will be found if we take all of the items of

INCREASES OF ASSETS AND DECREASES OF LIABILITIES:

Cost of Property.....	(increase)	\$53,582,818
Inventories	(increase)	3,939,355
Investments	(increase)	26,599,805
Capital Stock	(decrease)	8,258,633
Accounts Payable.....	(decrease)	<u>2,912,655</u>
Total		<u><u>\$95,293,266</u></u>

We have thus fully accounted for the expenditure of the funds. That part of the funds expended which was not derived from an increase in the bonded debt, less retirement of share capital with the small increase in Bills Payable, came from the earnings of the company and collections of accounts.

A Study of Earnings

We have one more fact, obtained from the

public records, showing that this company paid 7 per cent. dividends during 1911 on its entire capital stock; an aggregate of over \$24,000,000 being so disbursed. Taking this fact into consideration with the balance sheet, where we see an increase in the surplus and reserve accounts of nearly \$24,000,000, it will be seen that this company earned about 14 per cent. on its capital stock.

When we know something about the earnings of a corporation we can go still further in a dissection of its balance sheet. In one case it was claimed by parties interested that a certain corporation was charging off for depreciation entirely too large an amount. Upon analysis it was found that the depreciation charge for the year was \$270,000. The amount of this depreciation charge was stated as a Reserve for Replacement, the annual amount being charged to the Profit and Loss account and credited to the account as described. Condensed statements of assets and liabilities and earnings only were submitted. The increase in the amount of the plant during the last year aggregated

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\$407,375.12, while the capital account was not increased at all.

An analysis was made as follows:

Net earnings from operations.....	\$485,330.33
Add increase in current liabilities....	27,648.65

\$512,978.98

Deduct increase in current assets....	42,392.64
---------------------------------------	-----------

\$470,586.34

Reserve account at the beginning of the year.....	\$60,133.63
Add appropriation for the year.....	270,000.00

Amount available for replacements during the year.....	\$330,133.63
Amount of Reserve account at end of year	266,922.41

Amount expended in replacements... \$63,211.22

Now if we bring down the amount of available funds as shown in the foregoing statement, \$470,586.34, and deduct the amount expended for replacements of worn-out equipment, \$63,211.22, we have a re-

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mainder of \$407,375.12, which represents the amount taken out of earnings to provide new capital items, agreeing with the difference between the plant account at beginning and ending of the year.

Two things are observed here. First, the management, instead of paying dividends, used the earnings to buy additional plant; and, second, the depreciation charge to Profit and Loss for the purpose of providing a reserve for the replacement of worn-out equipment was larger than was actually necessary.

The cash earnings of the company were thus consumed and no dividends declared—a matter in which the stockholders would naturally be interested.

Tracing Increases of Assets

Another interesting phase of increased assets is shown in the following comparison of two balance sheets of the Rodman Production Company, taken at the close of two successive years:

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Assets

	1908	1909
Cash	\$27,370.77	\$17,909.97
Accounts Receivable....	165,659.31	146,293.18
Stock	97,049.75	496,439.80
Real Estate.....	223,329.30	251,572.52
Good-Will	150,000.00	150,000.00
Deficit	50,123.99	.
	<u>\$713,533.12</u>	<u>\$1,062,215.47</u>

Liabilities

Notes Payable.....	\$133,565.96	\$165,989.59
Accounts Payable....	79,967.16	230,026.21
Surplus		166,199.67
Capital Stock.....	500,000.00	500,000.00
	<u>\$713,533.12</u>	<u>\$1,062,215.47</u>

It will be noticed that on the face of the statements this company did remarkably well during the last year, changing a deficit or impairment of its capital in the amount of \$50,123.99 to a surplus of \$166,199.67. If we had access to the books we would probably find that these two amounts added together represent the credit to the Profit and Loss account as its earnings for the year.

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But note carefully the increase and decrease of assets and see whether anything exists there to warn us against a too quick conclusion that the company has actually made all of the money that the improved condition of its Surplus account would seem to indicate.

The cash and accounts receivable among the assets decreased about \$28,000, and the notes and accounts payable increased about \$180,000. But notice the increase in the stock of manufactured goods, the amount in excess of that of the previous year being nearly \$400,000.

The first thought which comes to mind is that the stock has been piling up. Then one is inevitably moved to ask at what price the goods were valued in the inventory. If taken at actual cost, the profit on the goods actually sold during the year is remarkable. But if the inventory was taken at selling price, the large increase of stock is seen to be less than it appears to be, and the large profit apparently made in the one year is partly explained as a book profit, not of course actually earned.

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It is obvious that if finished goods are inventoried by the manufacturer at any value above cost, it will be possible for him to manufacture a large stock of goods, and show a profit, without selling a dollar's worth.

This concern borrowed about \$180,000 additional capital, and probably put it all into the increased stock, which if carried at cost might show an increase of approximately the amount borrowed; this in addition, of course, to the increase made possible by the expenditure of funds arising out of the profits on the business which was actually transacted.

Since the stock increased to an amount over twice the amount of additional capital obtained, it may be quite necessary for an examination of the inventory values to be made, in order to determine whether the apparent profit was real and to eliminate any profit taken in advance of the actual sale of the goods.

In the case of a large tool manufacturing company, this method of inventorying was carried so far that in one year, when its sales

had decreased to about one-half of normal, it was not only able to pay the usual dividend, but to show in addition an increase in its Surplus account.

If this process could go on indefinitely the bed of a business man might easily be constructed of roses; but the practice of realizing on anticipated profits leads sooner or later to serious trouble.

There is no safe course for a merchant or manufacturer to pursue other than that based upon a complete understanding of his affairs. Such a statement, if prepared according to the outline which we have discussed in this little book, ought to furnish him with at least the foundation of that understanding.

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